

# **SELF-DEALING BY DIRECTORS**

by

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submitted pursuant to the requirements of the  
degree of Masters of Law by coursework and dissertation  
at the University of Malaya, Kuala Lumpur

Perpustakaan Universiti Malaya



A510233455

## ACKNOWLEDGEMENTS

First of all, I am deeply grateful to my supervisor, Professor Dato' P. Balan, for his guidance, patience and unceasing encouragement. This dissertation would not have been possible without his invaluable guidance.

I would also like to thank Professor Dato' Dr Mimi Kamariah Majid, the Dean of the Faculty of Law, for her kind support in so many ways. The encouragement of my colleagues at the Faculty of Law has also spurred me on many a time.

The completion of this dissertation would not have been possible without the unfailing inspiration and understanding of my husband, Eng Hong. His encouragement and patience through the many evenings and holidays I slipped away to work on this dissertation, and the late nights he spent on the format of this dissertation will always be treasured and appreciated.

My interest in self-dealing by directors was first inspired by May Yap, my ex-boss, with whom I have spent many hours researching such issues in the past. I am grateful to her for inspiring my interest in company law and for her encouragement in the writing of this dissertation.

I have been blessed with a wealth of family, friends and colleagues who have contributed in so many ways to the writing of this dissertation. To each of these, and especially to my parents-in-law and our friends from Damansara Utama Methodist Church, I am truly grateful.



Lastly, but most importantly, I thank God for His unfailing love, guidance and wisdom, and for being my Father and Friend. This dissertation is dedicated to His glory, for all that I am and all that I have is from Him alone.

*"Your love, O Lord, reaches to the heavens, Your faithfulness to the skies.*

*Your righteousness is like the mighty mountains, Your justice like the great deep.*

*How priceless is Your unfailing love! Both high and low among men find refuge in the shadow of Your wings."*

*Psalms 36:5-7*

TABLE OF CONTENTS .....	PAGE
TABLE OF STATUTES.....	I
TABLE OF CASES.....	II
CHAPTER 1 - INTRODUCTION.....	1
1.1 Objectives .....	2
1.2 Scope.....	3
1.3 Outline.....	4
1.4 Research Methodology .....	6
1.5 Problems and Limitations .....	7
CHAPTER 2 - DIRECTORS' DUTIES .....	8
2.1 Directors' Duties Against Self-Dealing.....	10
2.1.1 Fiduciary Duties .....	10
2.1.2 Statutory Duties .....	13
2.2 Directors' Duties: Perennial and Dynamic? .....	15
2.2.1 The Traditional Company v The Modern Company .....	16
CHAPTER 3 - THE NO-CONFLICT RULE .....	20
3.1 The General Principle .....	20
3.2 Relaxation of the No-Conflict Rule.....	23
3.3 Breach of the No-Conflict Rule .....	25
3.4 Statutory Duty of Disclosure .....	26
3.5 Critique of the Statutory Duty of Disclosure.....	31
3.6 Competition with the Company .....	34
CHAPTER 4 - THE NO-PROFIT RULE.....	40
4.1 Corporate Property .....	41
4.2 Corporate Information and Opportunity .....	43
4.2.1 Protection of the Company's Interests.....	47
4.2.1.1 Formulation of the no-profit rule.....	50
4.2.1.2 Statutory provisions.....	60
4.2.2 Limits to the Fiduciary Duty.....	63
4.2.2.1 Where the company is unable to obtain or exploit the opportunity .....	65
4.2.2.2 Where the corporate opportunity is rejected.....	66
4.3 A Corporate Opportunity Doctrine? .....	71
4.3.1 The American Corporate Opportunity Doctrine.....	72
4.4 Conclusion .....	78
CHAPTER 5 - STATUTORY REGULATION OF SPECIFIC TRANSACTIONS AND ARRANGEMENTS.....	83
5.1 Prohibited Transactions and Arrangements.....	84
5.1.1 Loans to Directors and Persons Connected with Directors - Sections 133 and 133A .....	86
5.1.1.1 Section 133 .....	86
5.1.1.2 Section 133A .....	89
5.1.1.3 The validity of a contract made in breach of Section 133.....	90
5.1.2 Substantial Property Transactions - Section 132E .....	96
5.1.2.1 The prohibition .....	96
5.1.2.2 Consequences of contravention.....	99
5.1.3 Transactions Involving Directors and Substantial Shareholders - Section 132G .....	102
5.1.3.1 The prohibition .....	103
5.1.3.2 Exceptions to the prohibition.....	105
5.1.3.3 Critique .....	107
5.2 Disclosure of Dealings by Directors.....	108



5.2.1	Sections 134 and 135.....	109
5.2.1.1	Section 134.....	110
5.2.1.2	Section 135.....	111
5.2.2	Section 137.....	113
5.2.2.1	The rule in Section 137.....	113
5.2.2.2	Exceptions to the rule.....	115
5.2.2.3	Payment made in connection with the transfer of the shares of the company.....	116
5.2.3	Section 169.....	116
5.2.4	The Effectiveness of Disclosure.....	118
5.3	The Companies Legislation of Australia and the United Kingdom.....	120
5.4	Proposals for Legislative Reform.....	124
5.4.1	Public Companies v Private Companies.....	125
5.5	Conclusion.....	128
CHAPTER 6 - CASE STUDIES.....		132
6.1	A Berhad's Acquisition of the Shares of B Berhad.....	132
6.2	C Berhad's Disposal of D Sdn Bhd.....	134
6.3	E Berhad's Acquisition of Land from F Sdn Bhd.....	136
6.4	Conclusion.....	138
CHAPTER 7 - RATIFICATION.....		141
7.1	Who Can Ratify?.....	142
7.1.1	The General Meeting.....	142
7.1.2	The Board of Directors.....	144
7.1.3	Should Directors be Allowed to Vote at General Meetings to Ratify their Breaches?.....	145
7.1.4	Minority Shareholders: Practical Considerations.....	147
7.2	What Can Be Ratified?.....	149
7.3	Ratification of Breaches of Statutory Duty.....	153
7.4	Conclusion.....	155
CHAPTER 8 – RELIEF AND REMEDIES.....		160
8.1	Relief.....	160
8.2	Remedies.....	166
8.2.1	Rescission.....	167
8.2.2	Account of Profits.....	169
8.2.3	Damages or Compensation.....	171
8.2.4	Constructive Trust.....	173
8.2.4.1	Third parties.....	173
8.2.5	Injunction.....	174
8.2.6	Dismissal of Directors.....	176
8.2.7	Critique of the Remedies.....	176
8.2.8	Remedies for Minority Shareholders.....	178
8.2.9	Institutional Shareholders.....	182
8.2.10	Conclusion.....	185
CHAPTER 9 - CONCLUSION.....		188
BIBLIOGRAPHY.....		193

## **TABLE OF STATUTES**

### **Malaysian statutes**

Companies Act, 1965 (Act 125)

Companies (Amendment) Act, 1985 (Act A616)

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## CHAPTER 1 - INTRODUCTION

Directors hold a significant position of influence over the assets and affairs of the company. This position gives rise to the potential for the misuse of the company's assets for the directors' own gain. In an era of marked growth of the significance of companies, there has been an increasing awareness of the need for protection of the company against abuse by directors.

In recognition of the position of influence held by directors, equity has regarded directors as fiduciaries. Fiduciary duties to the company have been imposed on directors, specifically constraining self-dealing by directors.

The Malaysian legislature introduced further statutory provisions regulating self-dealing by directors in the Companies Act, 1965 (Act 125) in response to the perceived need to strengthen regulation against self-dealing. Specific provisions of the Companies Act, 1965 (Act 125) and subsequent amendments<sup>1</sup> have supplemented the equitable fiduciary duties against self-dealing. In particular, the statutory provisions have highlighted various situations involving potential self-dealing by directors, and attempted to curb self-dealing in those situations.

Since the recent economic crisis of 1997, the problem of self-dealing has attracted substantial public interest. Various corporate transactions have been the subject of controversy, particularly where directors have appeared to have engaged in self-dealing to the detriment of the company. Shareholders have raised an outcry against the alleged self-dealings by directors. Calls have been made for the strengthening of corporate

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<sup>1</sup> Companies (Amendment) Act, 1985 (Act A616), Companies (Amendment) Act, 1986 (Act 657), Companies (Amendment) (No. 2) Act, 1992 (Act A836), Companies (Amendment) Act, 1993 (Act A845).

governance,<sup>2</sup> in order to establish investor confidence in Malaysian share markets. Invariably, the adequacy of the regulatory provisions relating to self-dealing have been called to question.

In response to such questions, this dissertation examines the existing laws regulating self-dealing. The specific objectives of this study are as set out below.

## 1.1 Objectives

The first of the objectives of this dissertation is to examine the existing duties of directors in relation to self-dealing. These include the duties imposed on directors, both by equity as well as by statute. The question as to whether these existing rules adequately address the current need for regulation of self-dealing will be considered.

In studying the existing laws on self-dealing, this study recognises some of the inadequacies of the existing laws regulating self-dealing by directors. The second objective of this dissertation is to identify some of the measures which may be taken to address these inadequacies. Particular focus is given to potential statutory amendment of existing laws.

A survey of the law relating to self-dealing would be incomplete without considering the possibility of ratification of directors' breaches of duties against self-dealing. Hence, the third objective of this dissertation is to consider the conditions on which

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<sup>2</sup> Corporate governance is concerned with entrusting directors with responsibilities and duties in relation to the direction of a company's affairs. This includes duties to restrain directors from abusing their powers and engaging in self-dealing. See for example Sheikh, S. and Chatterjee, S.K., 'Perspectives on Corporate Governance', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 5.

directors' breaches of duty may be ratified. The implications of ratification on the company and its shareholders will also be discussed.

As the remedies which may be obtained by the company for a breach of directors' duties form an integral part of the problem of self-dealing, the fourth objective will be to survey the remedies available for a breach of directors' duties against self-dealing. In discussing the available remedies, some of the factors which impede the enforcement of these remedies will also be considered. In particular, attention will be given to the perspectives of minority shareholders.

## **1.2 Scope**

This study is confined mainly to statutory provisions and judicial decisions relating to self-dealing. The relevant statutory provisions regulating self-dealing are found in the Companies Act, 1965 (Act 125). Duties against self-dealing are also imposed on directors by equitable principles. These equitable principles are found in case law. Ratification of breaches of directors' duties and the remedies available to the company in the event of a breach of directors' duties are also considered, as they are an integral part of the issue of self-dealing.

Brief mention is made of directors' competition with the company and minority shareholders' remedies. The study of self-dealing would be incomplete without considering these issues. However, it is not intention of this study to examine these matters in detail, as they merit in depth study on their own.



This study does not extend to a study on insider trading. Similarly, the position of nominee directors is not discussed. Both of these issues require separate treatment on their own.

The law clearly accords to the company legal rights and remedies in the event of self-dealing by directors. Nonetheless, there are practical impediments to the enforcement of the company's rights and remedies. In view of these practical impediments, judicial and statutory remedies alone may be ineffective to address the problem of self-dealing. Extra-judicial remedies may be required as an alternative solution. These issues are briefly considered in this dissertation. However, it is not the intention of this dissertation to examine these issues in detail.

### **1.3 Outline**

This dissertation is divided into separate chapters, each of which concentrates on a specific area of study.

Chapter 2 seeks to establish the basis for directors' duties against self-dealing. It also explores the need for these duties to adapt to the changing circumstances of companies as they develop.

In Chapter 3, a survey is made of the first of the equitable duties against self-dealing, namely the no-conflict rule. The application of the rule to Malaysian corporate situations is considered.

Chapter 4 studies the no-profit rule, the second of the equitable duties against self-dealing. The chapter focuses on an area of significant controversy, namely the

exploitation of corporate opportunity by directors for their own gain. The limitations of the no-profit rule and suggestions for legislative reform are considered.

The statutory duties which are imposed by the Companies Act, 1965 (Act 125) on directors in relation to self-dealing are reviewed in Chapter 5. Comparisons are made with legislative provisions of two other Commonwealth jurisdictions, namely Australia and the United Kingdom. The limitations of the Malaysian statutory provisions are discussed. The chapter also explores potential measures for reform of the existing legislative provisions.

Chapter 6 consists of case studies of various corporate transactions, which are scrutinised in the light of the existing laws regulating self-dealing. The case studies illustrate the limitations of the existing Malaysian laws on self-dealing.

In Chapter 7, the conditions on which the directors' breaches of duties may be ratified are studied. Particular attention is given to the issue of who may ratify such breaches on behalf of the company. The effect of ratification on the company's right to recourse against errant directors is also examined.

Chapter 8 consists of two sections. In the first section, the statutory provision allowing directors relief from liability for breaches of directors' duties are surveyed. The conditions for the granting of relief are explored. The second section of the chapter discusses the remedies available to the company for breaches of directors' duties. Specific emphasis is placed on the position of minority shareholders of the company in relation to the remedies. The unique position of institutional shareholders in influencing the corporate governance of companies is also canvassed.



Chapter 9 concludes the dissertation. The chapter reviews the need for reform of the existing laws regulating self-dealing. Proposed measures for reform are canvassed in the light of various factors which influence the regulation of self-dealing.

#### **1.4 Research Methodology**

The research methodology adopted for this dissertation consists primarily of library research. Materials were obtained from text books as well as international and local law reports. Various provisions of the Companies Act, 1965 (Act 125) and the companies legislation of Australia and the United Kingdom were adverted to in the course of this study. Reference was also made to articles from local and international law journals, parliamentary debates and various senate committee reports.

Materials on corporate transactions forming the basis of the case studies were obtained from newspaper and journal articles. In addition, information disclosed by various public listed companies through KLSE Link was obtained through the relevant website. Press releases from the Securities Commission and the Kuala Lumpur Stock Exchange were also accessed through the internet.

The writing of this dissertation involved an in depth study and reading of cases, statutory provisions and materials from the resources mentioned above. For the purpose of a comparative study between the position on self-dealing in Malaysia and other Commonwealth jurisdictions, materials from various Commonwealth jurisdictions, especially Australia and the United Kingdom, were referred to. Proposals for legislative reform were based largely on the developments in Australia and the United Kingdom. As for the equitable principles, locally reported cases were referred

to wherever possible. Nonetheless, constant reference to cases of other Commonwealth jurisdictions was necessary due to the dearth of locally reported cases on the subject.

### **1.5 Problems and Limitations**

One of the main difficulties encountered in this study was in relation to the extent and depth to which various aspect of self-dealing should be covered. Self-dealing forms a part of the wider fiduciary obligations owed by directors to the company. In view of the limited scope of this study, endeavours had to be made to limit the extent to which various issues arising from fiduciary obligations were elaborated on.

The few reported cases and articles on self-dealing in Malaysia were also a limitation in this study of self-dealing by directors. As a result, where Malaysian authorities were lacking, reported cases and articles from other Commonwealth jurisdictions were resorted to, as being of persuasive influence.

The case studies in Chapter 6 have been inserted for the purpose of illustrating the limitations of the existing laws on self-dealing. While there is a need to examine existing laws against the background of reality, there is the opposing consideration of maintaining anonymity on the part of the companies. Consequently, efforts have been made to examine factual situations and issues which are realistic. At the same time, excessive details have been avoided so as not to resemble any particular company's transactions. No intentional reference has been made to the transactions of any specific company, and the writer apologises for any inferences to any particular company which may inadvertently arise.

## CHAPTER 2 - DIRECTORS' DUTIES

From a backwater in the 1950s, Malaysia's economy has experienced phenomenal expansion to become one of Asia's fastest-growing economies.<sup>1</sup> Companies have been a significant vehicle of this economic growth. In line with this, the share market has seen exceptional growth.<sup>2</sup> It currently features in the lives of a wide cross-section of the community. Shareholders are now from varied walks of life. They include the owners of family businesses, the man-in-the-street as well as those who own controlling stakes in large corporate conglomerates.

The pervasiveness of the influence of the company on Malaysian society was highlighted during the recent economic crisis of 1997. The impact of the crisis was significantly felt in the share market in which the market value of shares plunged sharply.<sup>3</sup> Among the pertinent consequences of this was the widespread default on loans, particularly where the collateral to the loans had been shares.<sup>4</sup> As a result, a notable number of companies and individuals found themselves in financial difficulty, and the repercussions were felt in various parts of society.

One of the issues that was the source of much concern during the crisis was the apparent misuse by directors of companies' assets to benefit themselves. This issue currently continues to be the focal point of much discussion. The basis of this issue is found in the separation of the ownership and control of companies. An examination of this issue requires consideration of one of the basic principles of company law, namely the notion that the company is a separate legal entity.

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<sup>1</sup> Gill, R., Asia Under Siege, (1998), 93; Asiaweek, 7 November 1997, 24; The Economist, 8 February 1997, 33.

<sup>2</sup> The Economist, 22 February 1997, 93.

<sup>3</sup> The Economist, 27 September 1997, 29.

<sup>4</sup> *Ibid.*



It is common knowledge that the company is an artificial entity, legally separate from the shareholders who own the company.<sup>5</sup> The company, being an artificial entity, also requires natural persons to manage the company. In some situations, the shareholders who own the shares of the company may also manage the company. However, at times, some shareholders may wish merely to own shares without involving themselves in the management of the company. Particularly with large companies having a large number of shareholders, there appears to be a tendency towards such a separation between the ownership and management of the company. In such circumstances, it may in fact be a practical impossibility for all shareholders to manage the business.

The increasing number of public listed companies has resulted in a large number of shareholders who are not involved in the management of the company. This, in turn, has highlighted the problems associated with the separation of ownership and management or control of the company.

Those who manage or control the company would also have control of its corporate assets. Such control over assets may at times give rise to the temptation to misapply those assets for the benefit of the manager or controller instead of the company as a whole.<sup>6</sup> Consequently, there arises a need to enforce loyalty from the managers or controllers of the company. This need is addressed by the imposition of duties of loyalty on the directors, who control and manage the company.<sup>7</sup>

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<sup>5</sup> *Saloman v A Saloman & Co Ltd* [1897] AC 22.

<sup>6</sup> See Whincorp, M.J., 'An Economic Analysis of the Criminalisation and Content of Directors' Duties', (1996) 24 *Australian Business Law Review* 273, 275-6; Sheikh, S. and Chatterjee, S.K., 'Perspectives on Corporate Governance', In *Corporate Governance and Corporate Control*, (Ed. Sheikh, S. and Rees, W.), (1995), 41.

<sup>7</sup> Whincorp, *supra* note 6, 277.

## 2.1 Directors' Duties Against Self-Dealing

Directors have power and control over the company's assets, and make decisions regarding dealings by the company. Propriety would expect that these directors exercised the powers vested in them in ways which are fair and just towards the owners of the company. After all, directors are appointed by the owners of the company. The powers over the company's assets are vested in directors by virtue of their appointment by the shareholders. However, proprietary rights over the company are vested in the shareholders. In many situations, the directors may have some proprietary rights in the company due to their ownership of shares of the company. In a large number of situations, however, the shares of the company would be held together with other shareholders who are not directors.

Nonetheless, where directors have control over corporate assets, this potentially allows directors to prefer their own interests over the interests of the company.<sup>8</sup> Hence, directors may at times choose to apply the company's assets for their own benefit instead of the company and its shareholders. It is this preference of one's own interests over the interests of the company that is the essence of self-dealing.

The potential for self-dealing by directors has long been recognised by the courts and the legislature. Consequently, a substantial body of case law as well as legislation has developed over time with the object of curbing the misuse of directors' powers.

### 2.1.1 *Fiduciary Duties*

The equitable duties of loyalty were first imposed on directors by the courts. Equitable principles applicable to fiduciaries have been held to extend to directors of companies.

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<sup>8</sup> *Ibid.*



These fiduciary duties are owed by directors to the company, rather than to individual shareholders.<sup>9</sup> Nonetheless, the interests of the company have generally been construed in terms of the interests of the shareholders as a general body.<sup>10</sup> This does not mean the interests of a majority of present members.<sup>11</sup> Rather, it refers to the interests of both present and future shareholders of the company as a whole.<sup>12</sup> Hence, the short-term interests of present members should be balanced against a long-term view of the company.

There are essentially two fiduciary principles which govern self-dealing by directors. They are commonly known as the no-conflict rule and the no-profit rule. Whilst both rules concern self-dealing by directors, each of the rules deals with different aspects of self-dealing. The no-conflict rule, in essence, prohibits directors from entering into engagements in which they have a personal interests conflicting with the interests of the company. The avoidance of such conflict is clearly an important ingredient of the duty of loyalty.<sup>13</sup>

The no-profit rule, on the other hand, deals with situations where the director makes a personal profit from his position as a director. Hence, it addresses situations where there is a connection or causal link between the profit made by the director and the use

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<sup>9</sup> *Percival v Wright* [1902] 2 Ch 421.

<sup>10</sup> *Gaiman v National Association for Mental Health* [1971] Ch 317, 330; Heydon, J.D., 'Directors' Duties and the Company's Interests', In *Equity and Commercial Relationships*, (Ed. Finn, P.D.), (1987), 123; Farrar, J.H. and Hannigan, B.M., *Farrar's Company Law*, (4th edition, 1998), 383.

<sup>11</sup> *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34; *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 218; *Howard Smith v Ampol Petroleum Ltd* [1974] 1 NSWLR 68, 79.

<sup>12</sup> *Gaiman v National Association for Mental Health* [1971] Ch 317, 330; Heydon, *supra* note 10, 123. It is noted that the interests of the company may also include other interests such as the interests of creditors, where the company is of doubtful solvency; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Walker v Wimborne* (1976) 50 ALJR 446; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215.

<sup>13</sup> Austin, R.P., 'Fiduciary Accountability for Business Opportunities', In *Equity and Commercial Relationships*, (Ed. Finn, P.D.), (1987), 148.

of his position in the company. The crux of this rule is the test of connection or causality.<sup>14</sup>

The no-conflict rule has at times been stated to be the more fundamental rule.<sup>15</sup> Nonetheless, one of the criticisms of the no-conflict rule is that it involves some ambiguity and uncertainty. It is not always clear what the director's duty to the company entails. Further, there is no principle for determining the scope of the fiduciary undertaking and the content of the duty to the company.<sup>16</sup> It has also been noted that the no-conflict rule is not adequate to deal with all cases of profit-making by directors.<sup>17</sup>

An example of situations in which the no-profit rule was breached, but did not involve a conflict of interests may be found in the cases of *Regal (Hastings) Ltd v Gulliver*<sup>18</sup> and *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*.<sup>19</sup> In both of these cases, the directors entered into transactions from which they made a profit. These transactions were entered into as a result of the opportunities which came to them in their capacity as directors. As such, they breached the no-profit rule. However, the companies concerned did not have the necessary funds for the transactions which the directors entered into. Thus, the companies could not themselves acquire the property. Hence, it is arguable that the no-conflict rule was not breached, as there was arguably no conflict with the interest of the company.<sup>20</sup>

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<sup>14</sup> *Id.* 149.

<sup>15</sup> *Id.* 147; *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373, 393.

<sup>16</sup> Austin, *supra* note 13, 147.

<sup>17</sup> *Id.* 148.

<sup>18</sup> [1942] 1 All ER 378.

<sup>19</sup> [1980] 2 MLJ 136.

<sup>20</sup> Beck's arguments to the contrary are, however, noted; Beck, S.M., 'The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered', (1971) 49 *Can Bar Rev* 80, 101.



Conversely, there may also be situations in which the no-conflict rule is breached but there is no breach of the no-profit rule.<sup>21</sup> Nonetheless, there is some overlap between the two rules. In many cases of profit-taking by directors, both rules would apply, and thus overlap significantly.<sup>22</sup>

### 2.1.2 *Statutory Duties*

Apart from equitable fiduciary duties, statutory provisions have been enacted which impose duties of loyalty on directors. Statutory regulation of self-dealing by directors was introduced in Malaysia with the enactment of the Companies Act, 1965 (Act 125).<sup>23</sup> Subsequent amendments have also introduced further provisions regulating specific situations of self-dealing.

These statutory provisions reinforce the general fiduciary duties of directors in a number of ways. Firstly, the provisions deal with specific instances of self-dealing. This is in contrast to the fiduciary principles which are general principles of fairly wide ambit. Where fiduciary principles set out essential principles of propriety, they are at times vague and not very precise. The statutory provisions complement the fiduciary principles by providing precise and concrete meaning to these principles. Hence, this enables fiduciaries to recognise the legal limits of what they can do. Similarly, the statutory provisions assist shareholders in recognising breaches of directors' duties.

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<sup>21</sup> In *Green v Bestobell Industries Pty Ltd* [1982] WAR 1, a manager who tendered for a government contract when he knew that his company would also tender, was held to be in breach of the no-conflict rule. Arguably, there was no breach of the no-profit rule as the tenders were called for by public announcement, and anyone was free to respond. Accordingly, it his profit did not arise in connection with his fiduciary office; Austin, *supra* note 13, 146.

<sup>22</sup> See for example *Yukilon Manufacturing Sdn Bhd v Dato Wong Gek Meng (No. 4)* [1998] 7 MLJ 551; *Avel Consultants Sdn Bhd v Mohamed Zain Yusof* [1985] 2 MLJ 209; *Houng Hai Kong v MBf Management Sdn Bhd* [1997] MLJU 313.

<sup>23</sup> It is noted that the earlier local companies legislation such as the Companies Ordinance 1940 did not contain any regulation on directors' self-dealing.



Secondly, the statutory duties assist in the enforcement of the fiduciary duties by providing for criminal penalties. This enables the public prosecutor to bring an action for breach of directors' duties. Due to the rule in *Foss v Harbottle*,<sup>24</sup> the proper plaintiff in respect of a breach of directors' fiduciary duties is the company and not the shareholders. Thus, where the company is controlled by those in breach of fiduciary duties, it may be impossible for an aggrieved shareholder to bring a claim against errant directors except in limited situations. Criminal penalties, however, assist such shareholders. They not only permit actions by the public prosecutor, but also provide some impetus for directors to avoid such behaviour and to take action against a fellow director who is in breach of his duties.

Thirdly, the statutory provisions impose additional duties on directors, which supplement the fiduciary duties. Fiduciary duties do not impose duties on directors to disclose information except where the directors wish to obtain the consent of the company to a potential breach of duty. However, statutory provisions have been enacted which require the disclosure of various specific details concerning the company. Hence, this enables shareholders to monitor the management and control of the company. This is of particular value to shareholders who are not involved in the management of the company. These shareholders would otherwise have no access to information regarding the management of the company. In addition, disclosure has also often been seen to operate as a deterrent against directors' misuse of powers. The rationale underlying this is that if directors knew their activities would be subject to public scrutiny, they would probably modify their behaviour to avoid public disapproval.<sup>25</sup>

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<sup>24</sup> (1843) 2 Hare 461.

<sup>25</sup> Farrar, *supra* note 10, 463.

## 2.2 Directors' Duties: Perennial and Dynamic?

As seen above, an important role of the statutory duties is to apply the general fiduciary principles to specific situations of self-dealing. Fiduciary duties espouse principles which are seemingly ageless. The essence of the fiduciary principles remains relevant to the issue of self-dealing by directors regardless of developments and changes in companies and their dealings. Nonetheless, the application of these principles may vary in accordance with changes in the corporate scene.<sup>26</sup> Consequently, as companies and their dealings change over time, the application of the fiduciary principles to specific situations of self-dealing may take different forms in order to address the relevant and current needs of companies.

A brief survey of the development of companies would reveal that companies have seen much change over the last century. The profile of the average company fifty years ago is likely to differ substantially from the average company today. As mentioned earlier, the statutory duties relate fiduciary principles to practical and specific situations. Accordingly, the statutory duties which were relevant to companies fifty years ago may no longer properly address the needs of the average company of today. It is imperative, therefore, that the statutory duties should be re-examined for the purpose of ensuring that they are relevant and adequately address the present needs of companies.

In determining whether the statutory provisions are relevant to and adequate for the present corporate scene, it is pertinent to consider some of the ways in which the modern company differs from the traditional company.

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<sup>26</sup> Gilligan, G.P., 'Regulating companies in an era of late-modernity', (2000) 21 The Company Lawyer 145, 145-8.



### 2.2.1 *The Traditional Company v The Modern Company*

Early entrepreneurs generally both owned and managed their businesses and companies.<sup>27</sup> Hence, the traditional profile of the company is the small, owner-managed company.<sup>28</sup> As companies have grown, it has resulted in larger numbers of shareholders holding a smaller proportion of shares each. In other words, the result is less concentrated shareholding with consequent greater power to management.<sup>29</sup> Hence, there has been a gradual shift of power from those who own the company to those who control or manage the company. In many large public companies, the top management have relatively small personal shareholdings.<sup>30</sup> Nevertheless, due to the spread of shareholdings in public companies, their shareholding enables them to have functional control over the companies.<sup>31</sup>

As mentioned earlier, the shift of power from those who own the company to those who control the company increases the potential for directors to engage in self-dealing and at the same time to cloak such self-dealing in a shroud of secrecy. Shareholders who are not involved in the management of the company have limited access to information on the dealings of the company. Accordingly, one of the consequences of the shift of power to those who control the company is the need for disclosure of information to shareholders. This enables shareholders to be informed, and to monitor dealings by directors on behalf of the company. The shift of power to those who manage or control the company also creates a greater need to enforce directors' duties of loyalty.

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<sup>27</sup> Farrar, *supra* note 10, 9.

<sup>28</sup> Sheikh, *supra* note 6, 163.

<sup>29</sup> *Ibid.*

<sup>30</sup> Farrar, *supra* note 10, 9.

<sup>31</sup> The Finance Committee on Corporate Governance notes that a distinguishing feature of the Malaysian corporate landscape is the number of public companies which have a significant shareholder whose shareholdings are such that he or she can exercise control of the company. Many Malaysian public companies are under the influence of one shareholder or a group of shareholders; Finance Committee on Corporate Governance, Report on Corporate Governance, February 1999, 62.



The second change in the corporate scene involves a change in the profile of shareholders. Traditionally, shares have largely been owned by those who ran the businesses. In contrast, there are now many shareholders who regard their shareholding purely as an investment, and do not engage in the management of the company. A significant amount of personal savings is now invested in company shares.<sup>32</sup> The average wage-earner may invest a part of his monies in shares in the hope of gaining some financial return for his investment. In addition, funds have been placed in companies through institutional investors such as pension funds, insurance companies and investment trusts.<sup>33</sup> The number and spread of investors, direct and indirect, has greatly increased.

It follows that although misconduct by directors is not a new problem, its consequences have spread more widely and affected more investors than in earlier times.<sup>34</sup> Hence, this heightens the necessity of curbing the occurrence of self-dealing by directors. It is evident that self-dealing, which generally depletes the company of its assets and deprives the company of various benefits, has the effect of undermining the company, depriving its shareholders of their investments. In an era of increasing globalisation, self-dealing also erodes the confidence of both local and foreign investors in companies, and has the undesirable result of undermining the credibility and value of Malaysian companies as investment opportunities.

Thirdly, one of the by-products of the placing of funds in company shares as a form of investment is the involvement of institutional investors in companies. These institutional investors frequently have substantial shareholding in large public listed companies. Such shareholding may often be equivalent to the controlling shareholding

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<sup>32</sup> Sheikh, *supra* note 6, 145.

<sup>33</sup> Farrar, *supra* note 10, 10.

held by the controllers of these large companies. Hence, institutional investors would appear to be able to exercise material influence on the management of the companies. Particularly in large public listed companies where the shareholding is less concentrated, the substantial shareholding held may frequently confer on institutional investors sufficient influence to obtain disclosure of information on important dealings by the company. Similarly, they may be able to significantly influence any resolution put before shareholders at a general meeting. In addition, they may also function as a check on the controllers against self-dealing.

The potential influence of institutional investors on the management of companies has in recent times acquired increasing recognition.<sup>35</sup> In the United Kingdom for instance, institutional investors have exercised their influence as shareholders to monitor compliance by directors with their duties of loyalty.<sup>36</sup> Hence, the shift of power from owners to controllers of the company, resulting in greater potential for self-dealing, may be ameliorated by the influence of institutional investors.

Fourthly, another important modern development in companies is the development of increasingly elaborate structures among companies.<sup>37</sup> A large number of companies are now grouped into large groups known as conglomerates. These companies are frequently linked through shareholding. They often have subsidiaries in similar industries. They may also have related companies in a number of different industries.

One of the consequences of these conglomerates is that companies frequently enter into transactions within the conglomerate. These transactions may at times involve terms

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<sup>34</sup> Green, O., 'Corporate Governance - Great Expectations', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 145.

<sup>35</sup> Potter, J., 'The Role of the Institutional Shareholders' Committee', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 284.



which are more favourable to a party than an ordinary 'arm's-length' commercial transaction, if the parties are related. However, it may often also be the case that the directors of these companies may have a personal shareholding in a number of these companies. Hence, the transactions are complicated with issues of potential self-dealing which may not easily be detected by the shareholders, given the complex relations between the companies.

Some of the pertinent changes in the corporate scene have been examined above. As mentioned at the beginning of this section, although the essence of directors' fiduciary duties is essentially perennial, the application of these principles should adapt to the changing needs of companies. Hence, the directors duties, especially statutory duties which apply the principles to more concrete situations, should not remain static, lest they become stale and lose their effectiveness. Rather, these rules which assist in the application of principles should be dynamic, adapting to changes within the corporate scene, in order to address the needs of companies as they change and develop.<sup>38</sup>

This raises the question of whether the directors' duties against self-dealing in Malaysia adequately address the present needs of companies. This dissertation seeks to find some answers to this question. In the following chapters, the quest for such answers commences with an examination of the fiduciary duties of directors, the essence and origin of directors' duties against self-dealing.

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<sup>36</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1982] Ch 204; Farrar, *supra* note 10, 580.

<sup>37</sup> Farrar, *supra* note 10, 9.

<sup>38</sup> Gilligan, *supra* note 26, 145-8.



In *Yukilon Manufacturing Sdn Bhd v Dato Wong Gek Meng (No. 4)*,<sup>6</sup> two directors of Company A incorporated a company, Company B, to manufacture the products which were then being manufactured by Company A. The intention was to divert Company A's business to Company B, at the expense and to the detriment of Company A. The two directors then took steps to cause Company A to cease operations. These directors were found to have breached the no-conflict rule. By preferring their personal interest and their duty to Company B over the interest of Company A, they had breached their fiduciary obligations to Company A.

A literal application of the no-conflict rule could give rise to difficulties in various commercial contexts.<sup>7</sup> For instance, according to the strict formulation of the no-conflict rule, a director could not hold shares in the company, and would encounter difficulties where the director had a directorship in a competing company.<sup>8</sup> Thus, the modern courts in particular have been inclined to adopt a more practical approach.<sup>9</sup> The courts have in fact accepted that in certain situations a director can act despite having a personal interest, even though the director cannot be shown to have freed his mind of that personal interest when acting.<sup>10</sup> Directors can own shares in the company, and make decisions which could affect different classes of shares in different ways. The fact that they may benefit from their decision does not necessarily impugn their decision. The decision would be unlawful only if the directors' personal interests were the actuating motive rather than some bona fide concern for the benefit of the company.<sup>11</sup>

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<sup>6</sup> [1998] 7 MLJ 551.

<sup>7</sup> Ford, *supra* note 1, 306.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Id.* 307.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Mills v Mills* (1938) 60 CLR 150; Ford, *supra* note 1, 307.

The tendency of modern courts toward a more practical approach is also evidenced in Lord Upjohn's views in *Boardman v Phipps*.<sup>12</sup> In *Boardman v Phipps*, Lord Upjohn took the view that the no-conflict rule arises where there is a real sensible possibility of conflict, rather than an imagined situation of conflict.<sup>13</sup>

The rule that directors should avoid conflicts between the company's interests and the directors' own interests appears to be the essence of the duty of loyalty to the company. Nonetheless, a closer look at the no-conflict rule reveals that there appears to be little guidance as to what the rule actually entails.

Key elements of this rule are the company's interests, the directors' personal interests and the conflict between the two interests. The parameters as to what would be regarded as the company's interests, and what is deemed to be personal interests are not clearly spelt out. From case law, one may draw examples of these interests. However, there would also be situations which do not come within the examples from case law. Hence, it may at times not be clear whether the company would be deemed to have an interest in the matter, or whether the director would be considered to be interested. This may happen, for instance, where the director or the company has an interest which is rather indirect or remote.

For instance, consider a company which attempts to obtain a contract from a third party, but the third party chooses not to give the contract to the company, and subsequently awards it to a director of the company in his personal capacity instead. In such a situation, it is arguable that it was the director's duty to try to persuade the third party to change their minds and award the contract to the company.

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<sup>12</sup> [1967] 2 AC 46.



The company clearly had an interest in the contract initially. However, from the time the third party declined to give the contract to the company, the position becomes less certain. It is arguable that after continual rejection by the third party on the grounds that the company was not suitable, there should be a point at which the director's obligations to persuade the third party to give the contract to the company comes to an end. Consequently, the company's interest in the matter can be said to have ceased, or at most, any interest in the matter would be negligible. The third party may then subsequently choose to award the contract to the director in his personal capacity, based on his own merits, rather than that of the company. At that point, it may be argued that there would be no conflict of interest for the director to then accept the contract in his personal capacity.

Nonetheless, the company's interest in the matter is largely a question of degree. In the example above, this interest would seem to diminish over time, in line with the continual rejection of the company by the third party. Hence, there is some uncertainty as to the point at which the director would be free to pursue his own interests, without breaching the no-conflict rule.

### 3.2 Relaxation of the No-Conflict Rule

As the no-conflict rule is imposed essentially for the protection of those to whom fiduciary duties are owed, the rule may be relaxed by the persons entitled to the benefit of the rule.<sup>14</sup> Hence, a director may enter into a transaction in which he has a conflict of interest provided that the informed consent of the shareholders in general meeting is

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<sup>13</sup> *Id.* 124; This principle was followed by the Privy Council in *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1 and a similar principle referred to in *Chan v Zacharia* (1984) 154 CLR 178, 199 and *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, 103.

<sup>14</sup> See *Bray v Ford* [1896] AC 44, 51; *Imperial Mercantile Credit Association v Coleman* (1871) 6 Ch App 558; Davies, P.L., *Gower's Principles of Modern Company Law*, (6th edition, 1997), 611.



obtained. Under the common law, disclosure to the board of directors, rather than to the shareholders, is ineffective even if the interested directors refrain from attending and voting.<sup>15</sup> Accordingly, only full disclosure of the conflict of interest and ratification by the general meeting of the transaction would be effective to absolve a director from liability for breach of the no-conflict rule.

Nonetheless, this position may be modified by the provisions of the company's articles of association.<sup>16</sup> The company may by its articles permit directors to be interested in contracts with the company or other transactions in which the company is interested.<sup>17</sup> The effect of such articles would be to eliminate the need to present every contract in which the directors are interested to the general meeting.<sup>18</sup>

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<sup>15</sup> See *Imperial Mercantile Credit Association v Coleman* (1871) 6 Ch App 558, 567-8; *Benson v Heathorn* (1842) 1 Y & CCC 326, per Knight-Bruce V-C, 341-2.

<sup>16</sup> *Shanghai Hall Ltd v Chong Mun Foo* [1967] 1 MLJ 254.

<sup>17</sup> Examples of such articles are found in Article 85 of Table A of the Companies Act, 1985 (UK) and Section 231(1A) of the Corporations Law (Australia). Section 231(1A) of the Corporations Law (Australia) reads as follows:

*"If a director of a proprietary company has an interest in a contract or proposed contract with the company (other than as a member) and the director discloses the nature and extent of the interest at a meeting of directors:*

*(a) the director may vote on whether the company enters into the contract; and*

*(b) the contract may be entered into; and*

*(c) the director may vote on matters involving the contract; and*

*(d) if the disclosure is made before the contract is entered into:*

*(i) the director may retain the benefit under the contract even though the director has an interest in the contract; and*

*(ii) the company cannot avoid the contract merely because of the existence of the interest."*

It is noted that Section 231(1A) of the Corporations Law (Australia) is a replaceable rule. Consequently, it may be displaced or modified by the company's constitution; Section 135(2) of the Corporations Law (Australia).

<sup>18</sup> *Movitex Ltd v Bulfield* [1988] BCLC 104; *Woolworths Ltd v Kelly* (1991) 4 ACSR 431; Farrar, J.H. and Hannigan, B.M., *Farrar's Company Law*, (4th edition, 1998), 397. Whilst it is possible to entirely remove the duty of disclosure under common law, an attempt to exclude the statutory rule requiring disclosure of conflicts to the board of directors is unlikely to be effective; See Tomasic, R., Jackson, J. and Woellner, R., *Corporation Law: Principles, Policy and Process*, (2nd edition, 1992), 380. The statutory duty of disclosure is discussed in Section 3.4 below.

### 3.3 Breach of the No-Conflict Rule

In situations where a director breaches the no-conflict rule, the transaction will be voidable at the option of the company.<sup>19</sup> In addition, the director may be called to account for any profits he has made from the transaction.<sup>20</sup> This equitable rule is inflexible and will be applied regardless of whether the transaction is fair or otherwise.<sup>21</sup> The rigidity with which the equitable no-conflict rule is applied is reflected in the decision of the House of Lords in *Guinness v Saunders*<sup>22</sup>.

In *Guinness v Saunders*, the House of Lords did not permit a director to claim any payment for services rendered to the company, as such payment would have involved a conflict between his personal interest and his duty to the company. The fact that Mr Ward, the director concerned, had acted in good faith, believing that his services were rendered under contract binding on the company, was held to be irrelevant, as the no-conflict rule was found to override such considerations.

The no-conflict rule espoused in *Guinness v Saunders* was applied in the Malaysian case of *Avel Consultants Sdn Bhd v Mohd Zain Yusof*.<sup>23</sup> The defendants were directors of the plaintiff companies. The defendants obtained a contract for themselves in place of plaintiff companies without disclosing the same to the plaintiff companies. Subsequently, the defendants claimed professional fees pursuant to the contract. Richard Talalla J held that in claiming for themselves professional fees for work which

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<sup>19</sup> *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488. Note, however, that the right to avoid the contract may be lost if the company delays unduly, or has affirmed the contract, or *restitutio in integrum* is impossible, or of the rights of bona fide third parties intervene. This will be further discussed in Chapter 8.

<sup>20</sup> *Avel Consultants Sdn Bhd v Mohamed Zain Yusof* [1985] 2 MLJ 209.

<sup>21</sup> *Yukilon Manufacturing Sdn Bhd v Dato Wong Gek Meng (No. 4)* [1998] 7 MLJ 551; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461.

<sup>22</sup> [1990] 2 WLR 324.



was in fact done by the plaintiff companies, the directors were blatantly in breach of their fiduciary duty.<sup>24</sup> Consequently, the defendants were required to account to the plaintiff companies for the profit made pursuant to the contract. Apart from the equitable no-conflict rule, the judgment of the High Court also referred to the statutory provisions requiring disclosure of conflicts of interest.

### 3.4 Statutory Duty of Disclosure

In addition to the equitable no-conflict rule, statutory provisions which require disclosure of specific conflicts of interest have been introduced by the Companies Act, 1965 (Act 125). Section 131(1)<sup>25</sup> of the Companies Act, 1965 (Act 125) requires every director who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of directors of the company as soon as practicable after the relevant facts have come to his knowledge. The declaration may be made by a general notice given to the directors of the company specifying the nature and extent of his interest.<sup>26</sup> The notice must be given at a meeting of directors.<sup>27</sup> Alternatively, the director must take reasonable steps to ensure that it is brought up and read at the next meeting of the directors after it is given.<sup>28</sup> Section 131(1) is *pari materia* to Sections 317(1)<sup>29</sup> of the Companies Act,

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<sup>23</sup> [1995] 4 MLJ 146; See also *Lim Koei Ing v Pan Asia Shipyard & Engineering Co Pte Ltd* [1995] 1 SLR 499 for an application of a similar principle in Singapore.

<sup>24</sup> A similar conclusion was reached by the Singapore Court of Appeal in *Chew Kong Huat v Ricwil (Singapore) Pte Ltd* [2000] 1 SLR 385.

<sup>25</sup> Section 131(1) of the Companies Act, 1965 (Act 125) states that:

*"Subject to this section every director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company shall as soon as practicable after the relevant facts have come to his knowledge declare the nature of his interest at a meeting of the directors of the company."*

<sup>26</sup> See Section 131(4).

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

<sup>29</sup> Section 317(1) of the Companies Act, 1985 (UK) stipulates that:

*"It is the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company."*



1985 (UK) and Section 231(1)<sup>30</sup> of the Corporations Law (Australia), save that the aforesaid Section 231 is applicable only to proprietary companies.<sup>31</sup>

From the wording of Section 131(1) of the Companies Act, 1965 (Act 125), the crux of the Section appears to be the declaration or disclosure of conflicts of interests. In the case of *Tneu Beh v Tanjong Kelapa Sawit Sdn Bhd*,<sup>32</sup> Dato' Siti Norma bte Yaakob J appeared to place greater emphasis on the principle that the board of directors should be aware of the conflict of interest, rather than on the act of declaring or disclosing the conflict. In her judgment, Dato Siti Norma bte Yaakob J remarked that the purpose of the Section is to make all the directors aware of interests which one or more of the directors may have in a contract entered into with the company.

In this case, one of the directors, Boon Eu, had failed to disclose his interest in the contract at a board meeting. Nevertheless, all the directors were already aware of Boon Eu's interest in the transaction. Dato' Siti Norma bte Yaakob J found that Boon Eu had not contravened Section 131(1).<sup>33</sup> Her reasoning was based on the finding that the

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<sup>30</sup> Section 231(1) of the Corporations Law (Australia) reads as follows:

*"Subject to this Section, a director of a proprietary company who is in any way, whether directly or indirectly, interested in a contract or a proposed contract with the company shall, as soon as practicable after the relevant facts have come to the director's knowledge, declare the nature of the interest at a meeting of the directors."*

<sup>31</sup> As regards public companies, Section 232A of the Corporations Law (Australia) requires directors of public companies who have a 'material personal interest' in a matter that is being considered at a meeting of directors not to vote on the matter and not to be present while the matter is being considered. Although as a matter of strict construction, the director who has a material personal interest is not obliged to disclose the interest, Professor Ford observes that the practical effect of the Section is that the director is still under a duty to disclose his conflict of interest, as general equitable principles nonetheless subject him to a duty of disclosure. See Ford, *supra* note 1, 314. Whilst Section 131 of the Companies Act, 1965 (Act 125) applies to both private and public companies, additional requirements of disclosure are imposed on public listed companies by the guidelines of the Securities Commission as well as the listing requirements of the Kuala Lumpur Stock Exchange.

<sup>32</sup> [1995] 1 CLJ 741.

<sup>33</sup> This decision is in line with the Australian decision of *Woolworths Ltd v Kelly* (1991) 4 ACSR 431. The majority of the court held that the equivalent statutory provision did not require the director to formally disclose his interest if the other directors were plainly aware of that interest. Kirby P dissented, asserting that formal disclosure is desirable. He adopted the view that the duty to disclose is owed to the company itself rather than to the directors. The interest would not be

purpose of the Section is to make the directors aware of the interests which one or more of the directors may have in the contract. As the directors were aware of his interest, it was held that there was no contravention of the Section.

The purpose of Section 131 and the principle underlying the Section would seem to be the creation of awareness of the conflict of interest, so as to enable the board of directors to make an informed decision regarding the transaction. Nonetheless, on reading Section 131, there appears to be a clear requirement that the director concerned should declare his interest. In addition, the Section requires the company secretary to record such a declaration in the minutes of the meeting. The latter requirement, in particular, would ensure that a record is made of the conflict of interest. This would facilitate awareness of the conflict of interest not only among the directors present at that meeting, but also among other directors, such as those who are appointed at a future time. Where the contract is one that is continuing over a substantial period of time, such a record would facilitate the monitoring of the situation by directors appointed subsequently. Although it is arguable that the possibility of such a record being utilised may be fairly remote, it may nonetheless serve as a safeguard against self-dealing by directors.

In addition to the duty to disclose interests in contracts or proposed contracts with the company set out in Section 131(1), Section 131(5) requires directors to disclose conflicts with duties or interests arising out of the director holding any office or possessing any property.<sup>34</sup> In such situations, Section 131(5) requires the director

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known to shareholders unless formally disclosed to the board and minuted by the company secretary in accordance with the statutory provision.

<sup>34</sup> Section 131(5) of the Companies Act, 1965 (Act 125) states that:

*"Every director of a company who holds any office or possess any property whereby whether directly or indirectly duties or interests might be created in conflict with his duties or interests as director shall declare at a meeting of the directors of the company the fact and the nature character and extent of the conflict."*



concerned to declare at a meeting of directors of the company, the fact and the nature, character and extent of the conflict.<sup>35</sup>

The case of *Ngan Tuck Seng v Ngan Yin Hoi*<sup>36</sup> illustrates the strictness with which the duty under Section 131(5) is construed. In *Ngan Tuck Seng v Ngan Yin Hoi* Clement Skinner JC held that:-

*"the duty to disclose under Section 131(5) is so strict that all that is required is that there might be conflict of interest before the duty to disclose under Section 131(5) arises."*<sup>37</sup>

The case involved a company which owned an oil palm plantation in Sandakan, Sabah. One of the directors had personally acquired another oil palm estate close to the company's estate. It was argued on behalf of the company that the director had failed to disclose the conflict of interest arising from his acquisition of the oil palm estate and further that he had misappropriated financial and labour resources of the company for his own estate. The director argued that there was no conflict of interest, and therefore that there was no duty to disclose, as the articles of association did not prohibit him from being a director in another company. Nonetheless, the court held that the director should have had no difficulty in realising that there might be a conflict of interest, given that both estates were oil palm plantations where their needs would to a great extent be similar. Consequently, the court found the director to be in breach of his duty to the company.

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<sup>35</sup> Section 131(5) is *pari materia* to Section 231(6) of the Corporations Law (Australia). Section 231(6) of the Corporations Law (Australia) reads as follows:

*"A director of a proprietary company who holds any office or possesses any property whereby, whether directly or indirectly, duties or interests might be created in conflict with his or her duties or interests as director shall, in accordance with subsection (7),*



The statutory rules set out in Sections 131(1) and 131(5) appear largely to be restatements of the equitable no-conflict rule, except that they require disclosure to the directors of the company instead of the shareholders. Nonetheless, the statutory duties of disclosure only apply to a limited category of conflicts of interest, namely conflicts of interest arising out of a contract or proposed contract with the company or any office or property held by the director.<sup>38</sup>

These statutory duties are in addition to the duty of disclosure under the equitable no-conflict rule. The basis for this is found in Section 131(8) of the Companies Act, 1965 (Act 125).<sup>39</sup> This subsection specifies that Section 131 is in addition to and not in derogation of the operation of any rule of law or any provision in the articles restricting a director from having any interest in contracts with the company or from holding offices or possessing properties involving duties or interests in conflict with his duties or interests as a director. Consequently, in addition to disclosing the conflict of interest to the board of directors pursuant to the statutory duty, it would be necessary for the director concerned to obtain the consent of the company in general meeting as required by the equitable no-conflict rule.<sup>40</sup>

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*declare at a meeting of the directors of the company the fact and the nature, character and extent of the conflict."*

<sup>36</sup> [1999] 5 MLJ 509.

<sup>37</sup> *Id.* 525.

<sup>38</sup> Conflicts of interest such as the usurping of corporate opportunities by directors may often not be covered by the statutory provisions. Opportunities which have not reached the stage of becoming proposed contracts with the company would not come within the ambit of Sections 131(1) or (5); Davies, *supra* note 14, 627.

<sup>39</sup> Harun Mahmud Hashim (et al), *The Annotated Statutes of Malaysia*, 1995.

<sup>40</sup> See *Tan Kiong Hwa v Andrew S.H. Chang* [1974] 2 MLJ 188; *Boulding v Association of Cinematograph, Television and Allied Technicians* [1963] QB 137.

### 3.5 Critique of the Statutory Duty of Disclosure

As mentioned above, the statutory duty of disclosure appears to be largely a restatement of the equitable no-conflict rule. The equitable no-conflict rule espouses an essential aspect of the directors' duties of loyalty. Nonetheless, the parameters of key elements of the no-conflict rule are not clearly defined.<sup>41</sup> Apart from specifying a number of specific instances of conflict with the directors' personal interests such as the holding of any office, the possession of property and contracts with the company, the statutory duty appears to add little to the equitable no-conflict rule. One of the ways in which the statutory duty is of assistance is the stipulation of penalties for the contravention of the Section.

Section 131 provides for criminal penalties for contravention of the Section.<sup>42</sup> In contrast, contravention of the equitable no-conflict rule would result in the transaction being voidable at the option of the company. Alternatively, the director in breach of the rule may be called to account for any profits made. The severity of criminal penalties stipulated by statute would serve as a greater deterrent from self-dealing than the equitable remedies. This is so, particularly as the errant directors would not be able to avoid criminal penalties by attempting to procure the ratification of the impugned transaction.<sup>43</sup>

Notably, however, Section 131 does not expressly exclude the equitable no-conflict principle. Hence, there has been considerable debate as to whether in addition to the criminal penalties, the company will be entitled to avoid the impugned contract in the

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<sup>41</sup> Refer to Section 3.1 for a more detailed discussion of this point.

<sup>42</sup> See *Lim Foo Yong v Public Prosecutor* [1976] 2 MLJ 259.

<sup>43</sup> It is noted that there is some debate as to whether it is appropriate to use fiduciary duties as a basis for criminal provisions; Whincorp, M.J., 'An Economic Analysis of the Criminalisation and Content of Directors' Duties', (1996) 24 *Australian Business Law Review* 273, 290-1.



event of a breach of Section 131. Case law indicates that the company will have the right to avoid the contract in the event of a breach of the no-conflict rule, in situations where the articles of the company require the directors to disclose their conflicts of interests in accordance with the statutory requirement.<sup>44</sup> However, the position is less certain where the articles do not make any such provision. The *dicta* by Lord Pearson in *Hely-Hutchinson*<sup>45</sup> and Lord Goff in *Guinness v Saunders*<sup>46</sup> on the issue has led some commentators to the view that where the articles make no reference to the statutory duty of disclosure, contravention of Section 131 may not have any effect on the contract.<sup>47</sup> And as such, those contracts may remain unimpeachable.<sup>48</sup>

This issue is of particular importance in Malaysia, as the provisions of Table A of the Companies Act, 1965 (Act 125) do not expressly require compliance with Section 131.<sup>49</sup> It would be regrettable if companies were to be bound by contracts which are essentially entered into by directors in breach of fiduciary duties, due to the enactment of Section 131, where they would have been able to avoid the contract under common law. If a company is bound by a contract made in contravention of Section 131, it would enable a director to profit at the expense of the company notwithstanding that he

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<sup>44</sup> *Hely-Hutchinson v Brayhead* [1968] 1 QB 549; *Guinness v Saunders* [1990] 2 WLR 324. An example of such an article is found in Article 85 of Table A of the Companies Act, 1985 (UK).

<sup>45</sup> [1968] 1 QB 549.

<sup>46</sup> [1990] 2 WLR 324.

<sup>47</sup> Davies, *supra* note 14, 614; Baker, C.D., 'Disclosure of Directors' Interests in Contracts', (1975) *Journal of Business Law* 181, 184-6.

<sup>48</sup> Davies, *supra* note 14, 614. Professor Davies nonetheless concedes that as the articles in both the cases required compliance with the statutory provision, the judges did not have to consider what the position would otherwise have been and may not have directed their minds to the issue.

<sup>49</sup> Article 81 of Table A of the Companies Act, 1965 (Act 125) deals with directors' interests in contracts or proposed contracts with the company. It states that '*a director shall not vote in respect of any contract or proposed contract with the company in which he is interested or any matter arising thereout, and if he does so vote his vote shall not be counted*'. The Table A articles make no reference to the statutory duty of disclosure.



had breached his statutory duty. Such a conclusion could not be one that was intended by the legislature.<sup>50</sup>

It is submitted that even where the articles do not expressly require compliance with Section 131, the company would have the option of avoiding the contract when its directors breach the no-conflict rule. Equitable principles are clear that when directors breach the no-conflict rule, the transaction is voidable at the option of the company.<sup>51</sup> It is clearly stipulated that Section 131 is in addition to and not in derogation of the equitable principles.<sup>52</sup> As such, the equitable remedy of rescission should still be available notwithstanding the enactment of Section 131. Further, the historical background of the Section indicates that its purpose was for the protection of the company and its shareholders.<sup>53</sup>

Another notable feature of the statutory duty of disclosure is the fact that the disclosure is required to be made to the board of directors. As mentioned above, under the common law, disclosure to the board of directors, rather than to the shareholders, is ineffective. Accordingly, a lesser standard of disclosure appears to be required by statute than at common law. Professor Davies expresses some scepticism about the protective value of such disclosure for shareholders, particularly as fellow directors may be inclined to take a more lenient view of conflicts of interest especially if they

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<sup>50</sup> Davies, *supra* note 14, 614. Companies may avoid this problem by adopting an article which requires directors to comply with Section 131. Consequently, where Section 131 is breached, it would also amount to a breach of the provisions of the articles of association. As a result, a breach of the provisions of the articles would allow the company to have the option of avoiding the contract with the director: *Hely-Hutchinson v Brayhead* [1968] 1 QB 549; *Guinness v Saunders* [1990] 2 WLR 324.

<sup>51</sup> *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488. Note, however, that the right to avoid the contract may be lost if the company delays unduly, or has affirmed the contract, or *restitutio in integrum* is impossible, or of the rights of bona fide third parties intervene. This will be further discussed in Chapter 8.

<sup>52</sup> Section 131(8) of the Companies Act, 1965 (Act 125).

<sup>53</sup> Ford, *supra* note 1, 312.

entertain hopes of similarly lenient treatment should they themselves have to disclose a conflict in the future.<sup>54</sup>

### 3.6 Competition with the Company

As mentioned in Section 3.1 above, a strict interpretation of the no-conflict rule would mean that a director could not carry on or be associated with a business competing with that of the company. Nonetheless, case law indicates that a director can indeed act as a director of a rival company, provided that the director does not make use of the property of the company or confidential information which comes to him as a director of the company for the benefit of the rival company.<sup>55</sup> This principle was affirmed in *Shanghai Hall Ltd v Chong Mun Foo*.<sup>56</sup>

The case of *Ngan Tuck Seng v Ngan Yin Hoi*<sup>57</sup> concerned a competing business which was set up by one of the directors. The articles of the company neither expressly permitted nor prohibited its directors from holding an office in another company. The High Court found that in setting up a competing business without disclosing the same,

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<sup>54</sup> Davies, *supra* note 14, 629.

<sup>55</sup> This is provided that the regulations of the company do not require that the director's services be rendered to that company and to no other company; *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165; *Bell v Lever Bros Ltd* [1932] AC 161; *Berlei Hestia (NZ) Ltd v Fernyhough* (1980) 2 NZLR 150; *On the Street Pty Ltd v Cott* (1990) 3 ACSR 54, 61 per Powell J. What the director can do for a rival company, he can also do for himself; *Bell v Lever Bros Ltd* [1932] AC 161, per Lord Blanesburgh. An executive director, however, may be subject to an express or implied term that he must provide his services exclusively for the company; *Hivac v Park Royal Scientific Instruments Ltd* [1946] Ch 169; *On the Street Pty Ltd v Cott* (1990) 3 ACSR 54.

<sup>56</sup> [1967] 1 MLJ 254. In this case, Raja Azlan Shah J (as he then was) took the view that in the absence of a prohibition in the regulations of the company, a director is at liberty to become a director of a rival company. The paramount consideration would be whether the articles of association contain any such prohibition. It is noted that the articles of association in *Shanghai Hall* specified that the director could hold an office of profit in other companies subject to certain conditions.

<sup>57</sup> [1999] 5 MLJ 509.



the director had not only breached his fiduciary duty, but in addition, he had breached the statutory duty under Section 131(5) of the Companies Act, 1965 (Act 125).<sup>58</sup>

A significant factor in the decision in *Ngan Tuck Seng* is the fact that the director was found to have misappropriated the company's finances for his competing business. As such, he breached the condition on which directors are permitted to act for a rival company as stated in *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd*.<sup>59</sup>

Accordingly, in Malaysia, it appears that a director may compete with the company or hold a directorship in a rival company provided that he keeps within the limits of the principle in *London and Mashonaland*. However, there also arises the question of whether he must disclose the same to the of directors in accordance with Section 131(5) of the Companies Act, 1965 (Act 125).

As mentioned earlier, in *Ngan Tuck Seng v Ngan Yin Hoi*,<sup>60</sup> it was held that the duty to disclose under Section 131(5) arises where there 'might be conflict of interest'.<sup>61</sup> The Singaporean equivalent of Section 131(5), namely Section 156(5)<sup>62</sup> of the Companies Act (Cap 50) (Singapore), was considered in the recent case of *Yeo Geok Seng v Public Prosecutor*.<sup>63</sup> Yong Pung How CJ observed that Section 156(5) of the Companies Act

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<sup>58</sup> Section 131(5) had not come into effect at the time of the events complained of in *Shanghai Hall*. The Companies Act, 1965 (Act 125) came into effect on 15th April 1966 (P.U. 168/66), whereas the circumstances giving rise to the application in *Shanghai Hall* occurred in September 1965. The Companies Ordinance, 1940, which was the companies legislation in force at that time, did not impose any duty on directors to disclose conflicts of interest.

<sup>59</sup> [1891] WN 165.

<sup>60</sup> [1999] 5 MLJ 509.

<sup>61</sup> *Id.* 525.

<sup>62</sup> Section 156(5) of the Companies Act (Cap 50) (Singapore) states that:

"Every director of a company who holds any office or possesses any property whereby whether directly or indirectly duties or interests might be created in conflict with his duties or interests as director shall declare at a meeting of the directors of the company the fact and the nature, character and extent of the conflict."

<sup>63</sup> [2000] 1 SLR 195.



(Cap 50) (Singapore) is wide enough to impose a duty of disclosure on a director who holds a directorship in another company, as long as there is a potential conflict of duty arising from his office as a director in both companies.<sup>64</sup> He noted that the duty under Section 156(5) may not arise under every case of multiple directorships. The question as to whether such duty arises would depend on the circumstances, including the relationship between the companies.<sup>65</sup>

The interpretation accorded to Section 131(5) and its Singaporean equivalent by the above cases indicate that the statutory duty of disclosure, which arises where there 'might be a conflict of interest'<sup>66</sup> or there is a 'potential conflict of duty'<sup>67</sup>, appears to be stricter than the equitable duty of disclosure. As seen in Section 3.1 above, the equitable duty has been construed as arising where there is a real, sensible possibility of conflict, and not some situation which one may imagine might, in some conceivable possibility, result in conflict.<sup>68</sup> Consequently, under the statutory duty a director may be required to disclose a potential conflict of interest to the board of directors even where the equitable rule would not require disclosure.

It has been acknowledged that such a strict interpretation of the Section would mean that directors may fairly easily be caught by the Section. Even an innocent failure to disclose a potential conflict of interest, with no proven loss to the relevant company, could bring about the conviction of the director involved.<sup>69</sup> Nevertheless, in *Yeo Geok*

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<sup>64</sup> *Id.* 200.

<sup>65</sup> *Ibid.*

<sup>66</sup> *Ngan Tuck Seng v Ngan Yin Hoi* [1999] 5 MLJ 509.

<sup>67</sup> *Yeo Geok Seng v Public Prosecutor* [2000] 1 SLR 195.

<sup>68</sup> *Boardman v Phipps* [1967] 2 AC 46, per Lord Upjohn.

<sup>69</sup> *Yeo Geok Seng v Public Prosecutor* [2000] 1 SLR 195, 203, per Yong Pung How CJ. Section 131 of the Companies Act, 1965 (Act 125) provides for a penalty of imprisonment of seven years or one hundred and fifty thousand ringgit or both for contravention of the Section. Section 156(10) of the Companies Act (Cap 50) (Singapore) stipulates that any director who fails to comply with Section 156 shall be liable to a fine not exceeding \$5,000 or to imprisonment for a term not exceeding one year.

*Seng v Public Prosecutor*<sup>70</sup>, Yong Pung How CJ remarked that such an interpretation of the Section is necessary to give effect to its purpose, its purpose being:-

*"to assist in ensuring proper administration of the affairs of the company by preventing a director abusing his knowledge and powers for his own benefit and being put in a position where his duty may conflict with his interests".*<sup>71</sup>

He further reasoned that:-

*"This is a harsh reality but the fact remains that directors are under an onerous duty by virtue of their positions as fiduciaries entrusted with the responsibilities of managing their companies' businesses and making corporate decisions for the benefit of their companies. If a person undertakes such duties and responsibilities as a company director, he should also be responsible for familiarising himself with the various rules of disclosure and other statutory duties under the Act."*<sup>72</sup>

The decision in *Yeo Geok Seng v Public Prosecutor*<sup>73</sup> appears to be reflective of the current trend, both in Malaysia and the surrounding region, towards greater transparency, corporate reporting and corporate governance.<sup>74</sup>

Although the statutory duty of disclosure may be harsh, it is arguable that it is nonetheless justifiable. As mentioned in Chapter 2, the changes in the modern

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<sup>70</sup> [2000] 1 SLR 195.

<sup>71</sup> *Id.* 203; *Castlereagh Motels Ltd v Davies-Roe* (1966) 67 State Reports (NSW) 279, 284.

<sup>72</sup> [2000] 1 SLR 195, 203.

<sup>73</sup> [2000] 1 SLR 195.

<sup>74</sup> See Kuala Lumpur Stock Exchange 'ASAF 1999 Calls for Objective and Responsible Securities Reporting', 11 October 1999; Kuala Lumpur Stock Exchange, 'KLSE LINK Enhances Corporate Disclosure for Investors', 8 October 1999; Kuala Lumpur Stock Exchange, 'Companies to Promote Corporate Governance', 15 July 1999.



company, and in particular, the separation between ownership and control of the company, have increased the need for accountability by directors to shareholders. The effectiveness of the equitable no-conflict rule relies significantly on disclosure by directors. If directors conceal conflicts of interest, and other shareholders are unaware of the conflicts, the enforcement of the no-conflict rule would be impaired. Consequently, the statutory duty's stricter requirements of disclosure of conflicts of interests coupled with more onerous penalties<sup>75</sup> would be likely to enhance directors' accountability to shareholders. The harsher penalties would need to be balanced with the obvious injustice which could result to shareholders when directors engage in self-dealing and abuse their positions.

Further, an element of public interest is involved. The increase in the number and spread of investors who invest in shares has resulted in a significantly wider impact of the consequences of self-dealing. Self-dealing deprives shareholders of the value of their investments and undermines the credibility of Malaysian companies as investment opportunities. This, in turn, undermines the strength of our capital market<sup>76</sup> and erodes the competitiveness of our economy.<sup>77</sup> Along those lines, Dato' Mohd Azlan Hashim, the Executive Chairman of the Kuala Lumpur Stock Exchange stated that:-

*"Amongst various forces shaping the future of business, corporate reporting and corporate governance will play a significant role. Corporate reporting is*

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<sup>75</sup> Section 131 of the Companies Act, 1965 (Act 125) provides for a penalty of imprisonment of seven years or one hundred and fifty thousand ringgit or both for contravention of the Section. Section 156(10) of the Companies Act (Cap 50) (Singapore) stipulates that any director who fails to comply with Section 156 shall be liable to a fine not exceeding \$5,000 or to imprisonment for a term not exceeding one year.

<sup>76</sup> See Kuala Lumpur Stock Exchange 'ASAF 1999 Calls for Objective and Responsible Securities Reporting', 11 October 1999; Kuala Lumpur Stock Exchange, 'KLSE LINK Enhances Corporate Disclosure for Investors', 8 October 1999; Kuala Lumpur Stock Exchange, 'Companies to Promote Corporate Governance', 15 July 1999.

<sup>77</sup> *Ibid.*



*evolving towards a framework that requires high standards and rigorous interpretation whilst keeping pace with the changing needs of business.*"<sup>78</sup>

This is indeed an apt reminder of the importance of directors' duties of loyalty. It is also inherent that stringent standards of directors' duties need to be maintained. Among the most significant of directors' duties is the duty to avoid conflicts of interest, and to disclose such conflicts to the company. This duty of directors, whether imposed by statute or equitable principles, should be rigorously interpreted and enforced, for the benefit of the company as well as the corporate environment as a whole.

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<sup>78</sup> Kuala Lumpur Stock Exchange, 'NACRA '99 Honours Excellent Corporate Reporting', 18 November 1999.

## CHAPTER 4 - THE NO-PROFIT RULE

The principle that a director may not use for his own profit the company's assets, opportunity or information is another important principle relating to self-dealing by directors. The no-profit principle stems from the equitable principle that a fiduciary is not allowed to make any profit in the course of his duties as a fiduciary, without the informed consent of the person to whom he stands in a fiduciary position. The courts have traditionally taken a strict view of the principle which is succinctly stated by Laskin J:-

*"[A] director ... is precluded from obtaining for himself, either secretly or without the approval of the company, any property or business advantage either belonging to the company or for which it has been negotiating ... An examination of the case law in this Court and in the Courts of other like jurisdictions on the fiduciary duties of directors shows the pervasiveness of a strict ethic in this area of the law. In my opinion, this ethic disqualifies a director from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing."*<sup>1</sup>

The cases relating to the use of the company's property for a director's personal profit reflect the fiduciary principle that the company should be protected from any abuse of position by their directors. Where information and corporate opportunity are concerned, there is a clear need for similar protection of the company's interests.<sup>2</sup> However, attempts to prevent abuse of power have been fraught with many more

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<sup>1</sup> *Canadian Aero Services Ltd v O'Malley* (1973) 40 DLR (3d) 371, 382. This principle was applied in *Yukilon Manufacturing Sdn Bhd v Dato' Wong Gek Meng* (No. 4) [1998] 7 MLJ 551.



complexities in the areas of corporate information and opportunity. Both the areas of the misuse by directors of corporate property as well as the misuse of corporate information and opportunity will be further explored below.

#### 4.1 Corporate Property

A director's misuse of corporate assets for his own profit is clearly proscribed by the fiduciary duties of a director. Even the most unsophisticated director should realise that he must not use the company's property as if it were his own.<sup>3</sup>

The High Court case of *Ng Pak Cheong v Global Insurance Co Sdn Bhd*<sup>4</sup> illustrates the application of this principle. The facts of the case involved a scheme by the chairman of the company to purchase the assets of the company. At various board meetings comprising members of the chairman's family, the board purported to accept the chairman's offer to purchase the company's property. The board of directors also approved the transfer of the properties to the chairman. In the event that the sale had gone through, the chairman would have taken with him all the assets of the company, leaving behind a shell company.

Mohamed Dzaiddin FCJ held that the chairman had breached his fiduciary duties to the company. He had used the agreements as a scheme or device to appropriate the assets of the company to himself and for his own benefit, and had thus breached the no-profit rule.

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<sup>2</sup> It may be noted that information is at times regarded as part of the property of the company; *Pacifica Shipping Co Ltd v Andersen* [1986] 2 NZLR 328.

<sup>3</sup> Davies, P.L., *Gower's Principles of Modern Company Law*, (6th edition, 1997), 615.

<sup>4</sup> [1995] 1 MLJ 64.

In the recent case of *Simmah Timber Industries Sdn Bhd v David Low See Keat*<sup>5</sup>, Kamalanathan Ratman J found that the first defendant, a director of the plaintiff company, obtained a profit for himself, namely shares in the plaintiff company by a fraudulent device. This device involved the transfer of assets of the plaintiff company to a third party. Subsequently, the assets of the company which had been transferred and assigned were to be leased by the company. It was found that this arrangement was a clear case of fraud on the plaintiff company by its director. The company not only lost its assets but was further burdened with the additional liability of making monthly payments to lease-back the same assets it once owned. The first defendant was held to have breached his duty as a director of the plaintiff company and was required to account for all the monies received by him.<sup>6</sup>

In the situations above, the directors who misappropriated the property of the companies concerned were also found not to be acting in the interests of the companies to whom they owed fiduciary duties. As such, they were in breach not only of the duty not to make a personal profit by using the assets of the company, but also of their duty to act bona fide for the benefit of the company. It is envisaged in most cases involving the directors' making a profit from the use of the company's property, that the duty to act bona fide for the benefit of the company will also be breached. This is because the use of the company's property by directors to obtain a personal profit would in most cases invariably deprive the company of the use of those assets.

Where directors profit from the use of information obtained or opportunities discovered in the course of carrying out their duties, the complexities involved in ascertaining

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<sup>5</sup> [1999] 5 MLJ 421.

<sup>6</sup> Similarly, in *Ngan Tuck Seng v Ngan Yin Hoi* [1999] 5 MLJ 509, another recent case which came before the High Court, a director was found to have withdrawn monies from the respondent company's account for his own purposes. The High Court held that the director had failed to



whether there is a breach of fiduciary duties increase. Information and opportunities are far less tangible than property and hence it is not always clear what information or opportunities belong to the company. Unlike chattels or real property which physically belong to the company or to which the company has concrete evidence of title or ownership, corporate opportunity frequently has a much more intangible link to companies. Many opportunities may be subject to various contingencies before the opportunity can be said to have matured into a chose in action or other right which the company can definitively claim to be theirs.

#### 4.2 Corporate Information and Opportunity

As mentioned above, by virtue of his fiduciary position in relation to the company, a director is not allowed to use corporate information and opportunity to make a profit for himself, without the informed consent of the company. Should this restriction be violated, the director would then be liable to account to the company for the profit made. In practice, there would frequently be an overlap between corporate information and opportunity,<sup>7</sup> particularly as it is information which gives rise to the discovery of corporate opportunity.

The issue of directors profiting from corporate information and corporate opportunity is likely to be of increasing significance and importance in view of the current move towards a "K-economy". In the K-economy, knowledge is regarded as having a predominant role in the creation of wealth.<sup>8</sup> The K-economy seeks to effectively use and exploit of all types of knowledge in all manner of economic activity.<sup>9</sup> Knowledge

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discharge his duties to act in good faith and had accordingly breached his fiduciary duties to the company as a result of having misappropriated the respondent's finances.

<sup>7</sup> Davies, *supra* note 3, 615.

<sup>8</sup> UK Department of Trade and Industry, White Paper - "Our Competitive Future Building the Knowledge Driven Economy", December 1998; Bank Negara Malaysia, Annual Report 1999, 13.

<sup>9</sup> *Ibid.*

and information are, therefore, regarded as valuable assets of the company. Consequently, this highlights the need to protect corporate information from being misused by those in control of the company for their own benefit.

The equitable no-profit rule generally adopts a strict attitude against any exploitation of corporate information or opportunity by directors for their own profit. This is a position which is beneficial to the company. The decision of the House of Lords in *Regal (Hastings) Ltd v Gulliver*<sup>10</sup> illustrates the severity with which the no-profit rule has been applied. In *Regal (Hastings)*, the company were the owners of a cinema. They were anxious to acquire two other cinemas with a view to selling the property of the company as a going concern at a later date. For this purpose they incorporated a subsidiary company. The intention of the directors was that the first-mentioned company should hold all the shares of the subsidiary. They were offered a lease which required a guarantee of rent by the directors, unless the paid-up capital of the subsidiary was five thousand pounds. Hence, the directors decided that the paid-up capital of the subsidiary should be increased to five thousand pounds. The company was unable to provide capital of more than two thousand pounds. Consequently, the directors agreed that the company would subscribe for two thousand shares of one pound each, and the directors would subscribe for five hundred shares each. Five hundred shares were also allotted to the solicitor of the company. However, Gulliver, the chairman of the company, found people to take up five hundred shares instead of subscribing for those shares himself. Subsequently, the proposed sale and purchase of the Regal cinema and the leasehold cinemas fell through. Instead, the shares in the subsidiary company were at a later date sold at a profit.

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<sup>10</sup> [1942] 1 All ER 378.



The House of Lords held that the directors were liable to account for the profit they made on the shares. In a frequently quoted passage of his judgment, Lord Russell of Killowen remarked:-

*"My Lords, I have no hesitation in coming to the conclusion, upon the facts of this case, that these shares, when acquired by the directors, were acquired by reason, and only by reason of the fact that they were directors of Regal, and in the course of their execution of that office."<sup>11</sup>*

In their judgments, their Lordships acknowledged that the directors acted bona fide, intending to act in the interest of the company. Nevertheless, they were of the opinion that the fact that they acted bona fide was irrelevant. The directors were liable for the reason that they made a profit while standing in a fiduciary relationship to Regal.

The no-profit principle is targeted primarily at secret profit made by directors through the use of corporate assets, information or opportunity. Hence, in *Regal (Hastings)*, the courts acknowledged that the directors could have protected themselves by obtaining a resolution of the company in general meeting approving the directors' actions.<sup>12</sup>

Although the decision in *Regal (Hastings)* demonstrates a strict application of equitable principles, the decision has been criticised as having produced an inequitable result. The directors were held accountable whilst two of the parties who were most closely associated with the transaction, namely the chairman and the solicitor, were able to avoid liability. Moreover, the purchasers of the shares obtained a windfall gain, and

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<sup>11</sup> *Id.* 387.

<sup>12</sup> *Id.* 389.

although they had paid the agreed price for the shares of the company, were able to use the newly-acquired company to claw back some of the purchase money.<sup>13</sup>

In Malaysia the no-profit rule was held to be applicable in the case of *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*.<sup>14</sup> The facts of *PJTV Denson* concerned a sale agreement, in relation to land, entered into by the first appellant. The land was subsequently registered in the names of the directors of the first appellant instead of the first appellant. The first appellant averred that it did not complete the purchase due to lack of funds. It alleged that the directors had bought the land with their own money as a consequence. In the judgment of the Federal Court given by Raja Azlan Shah CJ (as he then was), the Federal Court applied the decisions in *Regal (Hastings)* and *Keech v Sandford*<sup>15</sup>, and decided that as trustees the directors could not purchase the land for the reason that the "inflexible rule of equity forbade them to do that", regardless of however honest they may have been in the circumstances.

It is clear from the authorities that one of the primary reasons for the strict imposition of this profit rule is for the protection of the companies in whose interests the directors are to act. However, this must be balanced with the requirement that a duty that is too harsh or onerous should not be imposed on the directors. The two opposing

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<sup>13</sup> Ford, H.A.J. and Austin, R.P., *Principles of Corporations Law*, (7th edition, 1995), 324. It is also noted that the directors also had held a majority of the shares of the company and hence there would have been no difficulty in obtaining a resolution of the shareholders of the company approving their actions. They had acted in good faith and in full belief of the legality and propriety of their actions, and it had not occurred to them to go through this formality. See also Davies, *supra* note 3, 616.

<sup>14</sup> [1980] 2 MLJ 136.

<sup>15</sup> (1726) Sel Cas Ch 61. The case of *Keech v Sandford* involved a trustee holding a lease on trust for an infant beneficiary who had been refused a renewal of the lease in his capacity as trustee, but had been given a lease of the same property for his own benefit. The trustee was ordered to assign the lease to the infant.



considerations were aptly described by Lord Buckmaster LC in the Privy Council decision of *Cook v Deeks*<sup>16</sup> in the following terms:-

*"It is quite right to point out the importance of avoiding the establishment of rules as to directors' duties which would impose upon them burdens so heavy and responsibilities so great that men of good position would hesitate to accept the office. But, on the other hand, men who assume complete control of a company's business must remember that they are not at liberty to sacrifice the interests which they are bound to protect, and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company they represent."*<sup>17</sup>

#### **4.2.1 Protection of the Company's Interests**

The facts of *Cook v Deeks* illustrate the need to impose restrictions on directors for the purpose of ensuring that the interests of the companies which the directors represent are duly safeguarded. As a company is an entity which functions primarily through human agents, the most significant of whom are its directors, it remains vulnerable to the actions and decisions of its agents.

In *Cook v Deeks*, some of the directors of the company proceeded to negotiate for a new contract on their own behalf. The contract concerned the construction of railway lines, which was the very business which the company carried on. These directors negotiated the contract in the same manner as they had always acted for the company. Their negotiations were enforced by the expeditious manner in which they, while acting for the company, had caused the previous contract to be carried through. It was only after

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<sup>16</sup> [1916] AC 554.

<sup>17</sup> *Id.* 563.

all the necessary preliminaries of the contract had been concluded that the directors informed the contracting party that the contract was to be made not with the company but with the directors themselves. Similarly, no mention was made to the company of the fact that the contract was to be made with the directors personally and not with the company, until the directors knew that they had obtained the contract for themselves.

The Privy Council found that the diversion of the contract for the directors' own profit amounted to a breach of their fiduciary duties, noting that:-

*"[T]hey intentionally concealed all circumstances relating to their negotiations until a point had been reached when the whole arrangement had been concluded in their favour and there was no longer any real chance that there could be any interference with their plans. This means that while entrusted with the conduct of the affairs of the company they deliberately designed to exclude, and used their influence and position to exclude, the company whose interest it was their first duty to protect."*<sup>18</sup>

The Privy Council found that the directors were 'guilty of a distinct breach of duty in the course they took to secure the contract'. The Privy Council further declared that the directors could not retain the benefit of the contract for themselves, but must be regarded as holding it on behalf of the company. Hence, we see the intervention of the equitable principle, resulting in the protection of the company's interest.<sup>19</sup>

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<sup>18</sup> *Id.* 562.

<sup>19</sup> A similar consequence was reached in the case of *Cranleigh Precision Engineering Ltd v Bryant* [1965] 1 WLR 1293, as a result of the intervention of the no-profit principle. The case involved the managing director of company A, which made swimming pools. This managing director learned of a rival patent for a swimming pool similar to that marketed by company A. He never disclosed this to the other directors, but instead introduced the manufacture of the swimming pool to company B, a company of which his wife and son were directors. He was held to have been in breach of his duty in concealing the existence of the rival patent. Further, in



The case of *Avel Consultants Sdn Bhd v Mohamed Zain Yusof*<sup>20</sup> also concerned the exploitation of corporate opportunity by directors for their personal profit. The directors of the company had formed a firm which was a rival to the company. They obtained for the rival firm a job which should have been given to the company. Further, the directors canvassed for work from the established clients of the company. The Federal Court held that the directors were clearly in breach of their fiduciary duties.

Similarly, in *Houng Hai Kong v MBf Management Sdn Bhd*,<sup>21</sup> the applicant was a director and shareholder of a company incorporated by the MBf group. The applicant procured a secret profit for himself through some transactions, and made elaborate efforts to conceal the profits. The court found that the applicant had breached the no-profit rule and was thus in breach of his fiduciary duties to the company.

In all of the above cases, the equitable rule against a director making a personal profit from his position intervened to prevent the companies from being deprived of corporate opportunity which should have accrued to the companies. Such intervention appears to accord with the purpose of the equitable principles, namely the prevention and deterrence of abuse of the fiduciary's position.<sup>22</sup>

In order for the no-profit rule to operate effectively, the scope of the rule should be sufficiently wide to impede attempts by directors to deprive the company of opportunity which should accrue to the company. Clearly, situations in which this may occur are

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making use of the information to his and company B's advantage, he had breached the no-profit rule.

<sup>20</sup> [1985] 2 MLJ 209.

<sup>21</sup> [1997] MLJU 313.

<sup>22</sup> Heydon, J.D., Gummow, W.M.C. and Austin, R.P., Cases and Materials on Equity and Trusts, (4th edition, 1993), 215.

likely to be varied, and the formulation of a rule which would produce an equitable result in the various circumstances would not be a simple task.

#### 4.2.1.1 Formulation of the no-profit rule

The principle espoused by Lord Russell of Killowen in *Regal (Hastings) Ltd v Gulliver*<sup>23</sup>, that a director is liable and should account to the company for profits acquired *by reason of* the fact that they were directors, and *in the course of* their execution of that office, has often been regarded as a significant statement of the no-profit principle.<sup>24</sup> However, this statement has been criticised as being too narrow to deal effectively with the problem of profit-taking by directors. The words 'by reason of' imply a causal limitation. This limitation implies that a fiduciary might be able to take advantage of a profit-making opportunity which comes to him in some capacity other than as a fiduciary.<sup>25</sup> According to Professor Austin:-

*"The causal limitation ("by reason of") suggests that a director, even an executive director, can wear two hats, and is exonerated from responsibility if the opportunity arises when his directorial Akubra is on the locker-room shelf."*<sup>26</sup>

The words 'in the course of' suggest a temporal limitation, that the obligation to account for a profit might be avoided by resignation from the fiduciary office before the

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<sup>23</sup> [1942] 1 All ER 378.

<sup>24</sup> The principle was cited in *Boardman v Phipps* [1967] 2 AC 46, *Peso Silver Mines Ltd v Cropper* (1966) 58 DLR 1, *Queensland Mines Ltd v Hudson* [1978] 52 ALJR 399, *Industrial Development Consultants v Cooley* [1972] 2 All ER 162, *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136.

<sup>25</sup> Ford, *supra* note 13, 320.

<sup>26</sup> Austin, R.P., 'Fiduciary Accountability for Business Opportunities', In *Equity and Commercial Relationships*, (Ed. , Finn, P.D.), (1987), 150.



opportunity is taken.<sup>27</sup> Both these limitations are obviously capable of giving rise to opportunities for manipulation of the rule and manifest injustice.<sup>28</sup>

Subsequent cases have dealt with situations which appear to test the boundaries of the restrictive test propounded by the House of Lords in *Regal (Hastings)*. *Industrial Development Consultants v Cooley*<sup>29</sup> is a case which involved a profit-making opportunity which came to a director seemingly in his personal capacity. In *Industrial Development Consultants v Cooley*, the plaintiff company offered comprehensive construction services to large industrial enterprises. In the course of his employment with the plaintiff, the defendant had corresponded with the Eastern Gas Board. The plaintiffs were interested in providing services to the Eastern Gas Board, but the Eastern Gas Board were not prepared to engage the plaintiffs as they did not like the set up of the plaintiff's organisation.<sup>30</sup> Subsequent to the plaintiffs having been turned down by the gas board, the deputy chairman of the gas board telephoned the defendant at his home, as they had heard that the defendant was thinking of going into private practice, and they thought that he was just the man the gas board needed for the project. Following discussions with the gas board, the defendant resigned from the company on the false representation that he was a sick man, in order to obtain an early release by the plaintiffs and secure the prospective contract with the Eastern Gas Board.

In his judgment, Roskill J held that the defendant was in breach of his fiduciary duty to the company, as he had made a profit as a result of having allowed his duty to the

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<sup>27</sup> Ford, *supra* note 13, 320.

<sup>28</sup> Austin, *supra* note 26, 150.

<sup>29</sup> [1972] 2 All ER 162.

<sup>30</sup> The success which the plaintiff company had attained had largely been in the private sector. The defendant was engaged by the company because he was considered to be 'an admirable person with whom to enter the public sector, in view of his connection with the gas industry'; *Ibid.* 164. Such facts clearly indicated that the company was interested in the contract with the gas board.

company to conflict with his personal interests. Roskill J's decision turned on the following:-

*"The first matter to be considered is whether or not the defendant was in a fiduciary relationship with his principals, the plaintiffs. Counsel for the defendant argued that he was not because he received this information which was communicated to him privately. With respect, I think that argument is wrong. The defendant had one capacity and one capacity only in which he was carrying on business at that time. That capacity was as managing director of the plaintiffs. Information which came to him while he was managing director and which was of concern to the plaintiffs and was relevant for the plaintiffs to know, was information which it was his duty to pass on to the plaintiffs because between himself and the plaintiffs a fiduciary relationship existed ..."*<sup>31</sup>

The test applied by Roskill J appears to have in fact addressed the causal limitation for which the test propounded by Lord Russell of Killowen in *Regal (Hastings)* has been criticised. As discussed above, the words 'by reason of the fact that they were directors' appear to imply that a director could escape liability if the corporate opportunity came to him in some way other than by reason of the fact that he was a director. Hence, a strict interpretation of the test may have led to the conclusion that a director would not be liable to account for profits made from an opportunity which came to his knowledge in his personal capacity. However, Roskill J held that notwithstanding that the information was communicated to the director privately, at his home, he nonetheless remained a fiduciary. Consequently, he had a duty to pass on to the company any

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<sup>31</sup> [1972] 2 All ER 162, 173-174.



information which was of concern to the plaintiffs and was relevant for the plaintiffs to know.

This duty appears to be significantly wider than the test in *Regal (Hastings)*. According to Roskill J's formulation of the profit rule, a director would be liable to account for profit even if it was acquired outside the execution of his duties as a director.

To the company and its shareholders, this formulation of the duty owed by directors is advantageous. It would prevent directors from taking for themselves opportunities which arise from circumstances which may be strictly outside the execution of a director's work but may nonetheless be of relevance and concern to them, such as business opportunities discovered at a social event while talking to a business associate.<sup>32</sup> From a director's point of view, this may seem rather onerous. The grounds on which a director may exploit an opportunity for his own profit are narrower and less certain. Further, there is a subjective element in the phrase "information which is of concern to the company and relevant for the company to know". This would involve questions regarding the degree of relevance or concern to the company.<sup>33</sup>

One of the anomalies of the outcome of this decision is the fact that the company obtained a windfall as a result of the director having to account for his profit.<sup>34</sup>

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<sup>32</sup> It has been argued that Roskill J's formula has potential to do justice more effectively than Lord Russell's test in *Regal (Hastings)*, noting that opportunities may be of equal concern and relevance to a company whether they arise on the golf course or in the boardroom; Austin, *supra* note 26, 150.

<sup>33</sup> This formulation of the profit rule has been criticised as being too broad and onerous, particularly where an unremunerated part-time director is concerned, and for the ambiguity of the words 'concern' and 'relevance'; Austin, *supra* note 26, 150-1.

<sup>34</sup> The facts of the case indicated that the Eastern Gas Board was not prepared to engage the plaintiff in any capacity since they did not like the set up of the plaintiff's organisation. Roskill J in his judgment acknowledged that by requiring the director to account for the profit made by him, the company would receive a benefit which they would probably not have obtained if the director had complied with his duty to them.

However, Roskill J took into account previous case law, such as *Keech v Sandford*<sup>35</sup>, which have treated as irrelevant the question whether or not the benefit would have been obtained but for the breach of trust. The overriding principle of equity is that a man must not be allowed to profit as a result of having put himself into a position in which his duty to the company and his personal interests conflict. Roskill J also remarked that:-

*"[T]here was always the possibility of the plaintiffs persuading the Eastern Gas Board to change their minds; and ironically enough, it would have been the defendant's duty to try and persuade them to change their minds. It is a curious position under which he whose duty it would have been to seek to persuade them to change their minds should now say that the plaintiffs suffered not loss because he would never have succeeded in persuading them to change their mind."*<sup>36</sup>

It would be honourable for directors to consider the company's interests to be of paramount importance, and hence, to subject their own interest to the interest of the company. However, requiring directors to account to the company for profits made even where it would have been impossible for the company to have succeeded in obtaining the same profit appears to be rather harsh. Justice would seem to require that there should be a point at which the company should acknowledge that it is unable to obtain those profits even with the best efforts of its directors. Hence, the company should be regarded as having ceased to be interested in the matter.

At such a point, it would seem fair to allow directors should be pursue such matters, without having to account to the company for profits received. This is so, particularly

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<sup>35</sup> [1558-1774] All ER 230.



where the directors are able to make those profits on their own merits, without using the position or information vested in them by virtue of their positions as directors of the company.

Similarly, the directors should ensure that in pursuing such matters, the interests of the company would not be compromised. Permitting this would arguably not be detrimental to the company, as the company which is unable to obtain the benefit for themselves would not suffer any loss. It would also have the advantage of ensuring that directors are not over-burdened with obligations to the company at unreasonable cost to themselves.

Nonetheless, it is acknowledged that where directors harbour hopes of personal profit, they may choose not to exercise their best efforts for the benefit of the company. Thus, there may be difficulties in ensuring that the company would genuinely be unable to obtain such profits. It follows that the more convenient alternative may be to prohibit directors from procuring any profits for themselves in areas in which the company has an interest, a position which is reflected in the equitable no-profit rule.

The second case which tests the boundaries of the profit rule as propounded by Lord Russell of Killowen in *Regal (Hastings)* is *Canadian Aero Service Ltd v O'Malley*.<sup>37</sup> Whereas *Industrial Development Consultants v Cooley* addresses the causal limitation of the *Regal* test, *Canadian Aero Service* deals with the temporal limitation.

*Canadian Aero Service* was a decision of the Supreme Court of Canada which involved the topographical mapping and aerial photographing of parts of Guyana, a project which Canadian Aero Service had been pursuing through O'Malley and Zarzycki.

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<sup>36</sup> [1972] 2 All ER 162, 176.

Subsequently, O'Malley and Zarzycki resigned from their positions with Canadian Aero Service and successfully obtained the Guyana project for themselves. The court found that O'Malley and Zarzycki were fiduciaries and were thus precluded from obtaining for themselves, either secretly or without the approval of the company, any business advantage for which the company had been negotiating.

The facts show that the fiduciaries, O'Malley and Zarzycki, obtained the Guyana project after having resigned from the company. As such, the temporal limitation implied by the phrase "acquired by the directors in the course of their execution of that office"<sup>38</sup> in the rule in *Regal (Hastings)* is brought to test. The Supreme Court of Canada took a radical step in declaring that the test of accountability for profits acquired 'by reason of being directors and in the course of execution of the office', reflected in the judgment of Lord Russell of Killowen in *Regal (Hastings)*, should not be considered as the exclusive touchstone of liability. Rather, new fact situations may require a reformulation of existing principles to maintain its vigour in new settings. The court opined that previous decisions<sup>39</sup> indicate "an updating of the equitable principle whose roots lie in the general standards [of] loyalty, good faith and avoidance of a conflict of duty and self-interest".<sup>40</sup>

In short, the decision in *Canadian Aero Service* is indicative of the Supreme Court of Canada's breaking away from the strict confines of the formulation of the profit rule espoused in *Regal (Hastings)*. In its place, the court held that the principle should be flexible rather than rigid, and should be based on general standards of loyalty, good

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<sup>37</sup> (1973) 40 DLR (3d) 371.

<sup>38</sup> [1942] 1 All ER 378, 387.

<sup>39</sup> Some of the decisions referred to by the Supreme Court of Canada in that case were *Industrial Development Consultants v Cooley* [1972] 2 All ER 162, *Boardman v Phipps* [1967] 2 AC 46, *Smith v Harrison* (1872) 27 LTR 188, *Furs Ltd v Tomkies* (1936) 54 CLR 583, and *G.E. Smith Ltd v Smith*; *Smith v Solnik* [1952] NZLR 470.

<sup>40</sup> (1973) 40 DLR (3d) 371, 384.



faith and avoidance of conflict of duty and self-interest.<sup>41</sup> These general standards must be tested in each case by many factors such as the position or office held, the nature of the corporate opportunity, its ripeness, its specificity and the director's relation to it.<sup>42</sup> This flexible approach has an edge over the more rigid approach of the House of Lords in *Regal (Hastings)*, for the reason that the facts surrounding different claims may be so varied that a rigid principle may not bring about justice or equity. Nevertheless, a loosely formulated principle brings with it a greater degree of uncertainty as to its application.

In relation to the facts of *Canadian Aero Service*, the court held that fiduciary principles:-

*"disqualify] a director from usurping for himself, or diverting to another person or company with whom or with which he is associated, a maturing business opportunity which his company is actively pursuing ... even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired."*<sup>43</sup>

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<sup>41</sup> *Id.* 391.

<sup>42</sup> The court also made reference to several other factors which include the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or private. The factor of time, in the continuation of fiduciary duty, where the alleged breach occurs after termination of the relationship with the company was also regarded as relevant. In addition, the circumstances under which the relationship was terminated would also be considered; *ibid.* This approach was affirmed in *Island Export Finance Ltd v Umunna* [1986] BCLC 460. See also *Balston Ltd v Headline Filters Ltd* [1990] FSR 385; *Framlington Group plc v Anderson* [1995] 1 BCLC 475 and Lowry, J. Edmunds, R., 'The No Conflict-No Profit Rules and the Corporate Fiduciary: Challenging the Orthodoxy of Absolutism', [2000] *Journal of Business Law* 122.

<sup>43</sup> (1973) 40 DLR (3d) 371, 382. This approach was followed in the New Zealand case of *Pacifica Shipping Co Ltd v Andersen* [1986] 2 NZLR 328. However, in *Island Export Finance Ltd v Umunna* [1986] BCLC 460, Hutchinson J took the view that the principle espoused was more widely stated than the facts in *Canadian Aero Service* required.

moulds used in manufacturing products and unlawfully utilised funds belonging to Company A for their personal gain.

In deciding the case, Abdul Malik Ishak J relied substantially on the principles espoused in *Canadian Aero Services*. Laskin J's views that the tests in *Regal Hastings v Gulliver* should not be considered as the exclusive touchstones of liability appeared to have been relied on. In addition, the assertion that previous decisions indicated an updating of the equitable principles whose roots lie in general standards of loyalty, good faith and avoidance of conflict of duty and self-interest were also cited.

However, notably, in the case of *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*,<sup>46</sup> the Federal Court rigidly applied the approach in *Regal (Hastings)*, notwithstanding that the decision was made subsequent to decisions such as *Industrial Development Consultants v Cooley*<sup>47</sup> and *Canadian Aero Service*. No mention was made of any of these later cases which extended the principle in *Regal (Hastings)*.

It is noted that *PJTV Denson* is a decision of the Federal Court. *Yukilon* was decided by the High Court. As such, the principle of *stare decisis* would require that the decision of the Federal Court should prevail.

Nonetheless, in view of the particular facts of *PJTV Denson*, the decisions in *Industrial Development Consultants v Cooley* and *Canadian Aero Service* may not have affected

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<sup>45</sup> [1998] 7 MLJ 551.

<sup>46</sup> [1980] 2 MLJ 136.

<sup>47</sup> The Singaporean case of *Hytech Builders Pte Ltd v Tan Eng Leong & Anor* [1995] 2 SLR 795 is a decision based on the equitable profit rule in *Industrial Development Consultants v Cooley* and *Keech v Sandford*. The director concerned had clearly obtained the corporate opportunity by reason of his office and the issue of the causal limitation of the *Regal (Hastings)* approach did not arise. As such, the court did not elaborate on whether in relying on *Industrial Development Consultants v Cooley*, the court was also adopting the wider formulation of the no-profit principle that a director has a 'duty to pass on to the company any information which was of concern to the plaintiffs and was relevant for the plaintiffs to know'.



the outcome of the case, even if they had been taken into account. The directors in *PJTV Denson* were clearly stated to have been directors at the time of the impugned transaction, hence the temporal factor which *Canadian Aero Service* addressed was not an issue. In a similar vein, the causal link between the directors' position and the corporate opportunity was unmistakably evident, as the opportunity to acquire the land was undoubtedly obtained by reason of their positions as directors.

From the judgment, it is not clear whether in applying *Regal (Hastings)*, the Federal Court intended the approach in *Regal (Hastings)* to be the exclusive touchstone of liability, or whether *Regal (Hastings)* was followed because the facts were sufficiently similar that there was no need for a reformulation of existing principles. It is also noted, however, that in *Yukilon* the facts also did not raise any issues regarding the temporal limitation or the causal link.

As seen above, there are merits to the contributions made by the decisions in *Industrial Development Consultants v Cooley* and *Canadian Aero Service* in the interest of equity. It is submitted that the developments made in *Industrial Development Consultants v Cooley* and *Canadian Aero Service* should be taken into account in order that the interests of the company may be duly protected from abuse by its directors.

#### 4.2.1.2 Statutory provisions

In Malaysia, the fiduciary principle against a director making a profit from information acquired by virtue of his position as an officer of the company is reflected in Section 132(2) of the Companies Act, 1965 (Act 125).<sup>48</sup> The Section essentially deals with

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<sup>48</sup> Section 132(2) of the Companies Act 1965 (Act 125) provides as follows:-

"An officer or agent of a company or officer of the Stock Exchange shall not make improper use of any information acquired by virtue of his position as an officer or agent of the company or officer of the Stock Exchange to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the company."

improper use of any information acquired by virtue of his position as a director of the company.<sup>49</sup> This raises the question of what would be considered as 'improper use'.

The Section itself does not define the meaning of the phrase 'improper use'. The Section only specifies that the 'improper use' of such information should be for the purpose of acquiring a direct or indirect advantage for the director, or for any other person.<sup>50</sup> Alternatively, the 'improper use' of such information should cause detriment to the company.

Section 132(2) is *pari materia* to Section 232(5) of the Corporations Law (Australia).<sup>51</sup>

The Australian courts appear to have declined to give the phrase 'improper use' a common inflexible meaning.<sup>52</sup> Instead, it has been remarked that what is proper must

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The section clearly applies to directors of a company given that the definition of 'officer' in Section 4 of the Companies Act 1965 (Act 125) includes any director.

<sup>49</sup> The Section also applies to other officers and agents of the company and officers of the Stock Exchange. However, the position of these other persons will not be discussed as it is beyond the ambit of this dissertation.

<sup>50</sup> The fact that the advantage received is reasonable does not preclude the finding that a director made improper use of information; *Cummings v Claremont Petroleum NL* (1992) 9 ASCR 58; Ford, *supra* note 13, 328.

<sup>51</sup> Section 232(5) of the Corporations Law (Australia) states that:

*"An officer or employee of a corporation, or a former officer or employee of a corporation, must not in relevant circumstances, make improper use of information acquired by virtue of his or her position as such an officer or employee to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation."*

<sup>52</sup> *McNamara v Flavel* (1988) 13 ACLR 619; *Grove v Flavel* (1986) 11 ACLR 161. In *McNamara v Flavel*, the director of the defendant company acquired information that the defendant was in serious financial problems and that liquidation was a real possibility. He then changed the name of the defendant company from 'Duna World Pty Ltd' to 'Dunquill Pty Ltd'. Then he procured another company to carry on business under the name of 'DunaWorld' which carried on the business of Dunquill Pty Ltd. As a result, Dunquill Pty Ltd was left with no business but all of its debts. The Supreme Court of South Australia held that the director had made improper use of information acquired as a director. The company and its creditors had suffered a detriment because of the actions of the director. He had not acted for the benefit of the company but had gained an advantage for himself by being able to trade using the name 'Duna World'. It is noted that the director's liability was based on Section 229(3) of the Companies (South Australia) Code which is *pari materia* to Section 232(5) of the Corporations Law (Australia) and Section 132(2) of the Companies Act, 1965 (Act 125). A similar reasoning was applied in *Grove v Flavel* (1986) 11 ACLR 161.



be determined by reference to the particular duties and responsibilities of the particular officer whose conduct is impugned.<sup>53</sup>

The consequences of a breach of Section 132(2) are two-fold, encompassing both civil and criminal liability. Pursuant to the said section, the officer who breaches the section shall be liable to account for the profit made by him or for any damage suffered by the company as a result of the breach. In addition, the officer will be guilty of a criminal offence.<sup>54</sup>

Section 132(2) appears largely to be a restatement of the equitable fiduciary principle that a director should not make a profit from the misuse of corporate information. Nonetheless, it fails to provide clarification of the ambiguities of the equitable principle. The ambit of Section 132(2) is narrower than the corporate opportunity principle, as it expressly deals with the use of information, rather than with corporate opportunity and corporate property. However, it goes further in that it provides that liability will ensue if the improper use of information results in either an advantage for the director, or for any other person, or causes detriment to the company. This would extend the application of the no-profit principle to situations where the director himself did not obtain a profit but enabled a third party to profit from the use of the corporate information. It is submitted that this would cover the situation of Gulliver in *Regal (Hastings)*, discussed above, as Gulliver himself did not make a profit, but the profit accrued to third parties by virtue of the corporate information and opportunity acquired through Gulliver. Section 132(2) would also apply to situations where the directors did

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<sup>53</sup> *McNamara v Flavel* (1988) 13 ACLR 619; *Grove v Flavel* (1986) 11 ACLR 161. In *Grove v Flavel* 43 SASR 410, Jacobs J remarked that the word 'improper' is to be understood in its commercial context to refer to conduct which is inconsistent with the proper discharge of duties. Ford reasons that Section 232(5) of the Corporations Law (Australia) seems to import a notion of wrongdoing which is narrower than the fiduciary principle. A director may breach his fiduciary duty while acting honestly; Ford, *supra* note 13, 330.

not make a personal profit, but their misuse of corporate information caused detriment to the company.<sup>55</sup>

Nonetheless, despite the presence of Section 132(2), it is submitted that the case law on the equitable rule against a director making a profit from the misuse of corporate information will still be applicable. Section 132(5) specifically states that Section 132 is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors. In addition, cases involving sub-section (1) of Section 132, which is similarly a restatement of the general fiduciary duties of a director, have also applied common law cases on the fiduciary duties of directors.<sup>56</sup>

#### 4.2.2 *Limits to the Fiduciary Duty*

As mentioned above, the need for protection of the company should be balanced with the requirement that a duty that is too harsh or onerous should not be imposed on the directors. If the protection of the company is carried to the extreme, this would discourage prudent persons from being directors. Nonetheless, the two considerations, namely the protection of the company, and, the need to limit the duty of directors, are directly opposed to each other. Consequently, restricting the extent of the duty owed by directors to the company would have the inevitable consequence of reducing the protection to the company.

From the viewpoint of a director, knowing which profit-making activities will amount to a breach of fiduciary duty is essential. A director cannot reasonably be expected to

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<sup>54</sup> Section 132(3) states that the defaulting officer will be guilty of an offence against the Companies Act, 1965 (Act 125) which has a penalty of imprisonment for five years or a fine of thirty thousand ringgit.

<sup>55</sup> Note that under equitable principles, loss flowing from failure by a fiduciary to discharge his fiduciary duties can be recovered; *Nocton v Lord Ashburton* [1914] AC 932; Heydon, *supra* note 22, 251.



avoid every profitable activity which may possibly be remotely related to the company. The issue as to when a director is free to pursue opportunities for his own benefit depends largely on the way we define the connecting link between profit and the fiduciary office. As seen in section 4.2.1 above, this connecting link has not been defined with certainty and the various formulations of the profit rule reflect the present indeterminate state of the law on corporate opportunity.<sup>57</sup>

In Malaysia, it is submitted that a director may not necessarily escape liability if he adheres strictly to the rule espoused in *Regal (Hastings)*, as *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*<sup>58</sup> arguably does not expressly reject the more liberal approaches. Further, the principles espoused in *Canadian Aero Service* have been applied in *Yukilon*. Arguments have been made in favour of limiting the duty of directors to business opportunities which are within the company's present or contemplated line of business.<sup>59</sup> This will be further explored in section 4.3 below.

Some of the other frequently explored possible limits to the duty of directors are, firstly, where the company is unable to obtain or to exploit the opportunity and, secondly, where the company has rejected the corporate opportunity and the director obtains the consent of the company or its directors to the utilisation of the opportunity for the director's own profit.

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<sup>56</sup> See *Simmah Timber Industries Sdn Bhd v David Low See Keat* [1999] 5 MLJ 421.

<sup>57</sup> The decisions involving corporate opportunity have been said to have little value as precedent since the judiciary too often has been content with the invocation of a formula ("a fiduciary must not make a profit") or a conclusory statement ("the property, in equity, belonged to the company") in a manner that is unsatisfactory for future reference. The cases rarely advert to what the policy of the law ought to be with respect to the extent of fiduciary duties; Beck, S.M., 'The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered' (1971) 49 *Can Bar Rev* 80, 86.

<sup>58</sup> [1980] 2 MLJ 136.

<sup>59</sup> See Austin, *supra* note 26, 152.

#### 4.2.2.1 Where the company is unable to obtain or exploit the opportunity

In a number of cases in which directors were alleged to have breached their duty not to make a profit from information or opportunities gained in relation to their positions, the directors attempted to raise as a defence the fact that the company would not have been able to obtain the opportunity,<sup>60</sup> or alternatively, was unable to exploit the opportunity.<sup>61</sup>

The courts have consistently taken a strict view of the fiduciary duty owed by directors and have concluded time and again that whether the company would have succeeded in securing the opportunity or could have exploited the opportunity is irrelevant.<sup>62</sup> The duty not to make a profit is overriding and directors should not in any way be allowed to be in a position in which they could compromise the interests of the company in favour of their own gain.<sup>63</sup> Permitting directors to take for themselves opportunities which the company cannot take may encourage and tempt directors not to develop the company, so as to be able to take more opportunities for themselves.<sup>64</sup>

However, the courts have envisaged an exception to the rule, the exception being that a director may exploit for himself opportunities which the company could not or did not

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<sup>60</sup> *Industrial Development Consultants v Cooley* [1972] 2 All ER 162; *Hytech Builders Pte Ltd v Tan Eng Leong* [1995] 2 SLR 795.

<sup>61</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136.

<sup>62</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136; *Furs Ltd v Tomkies* [1936] 54 CLR 583; *Industrial Development Consultants v Cooley* [1972] 2 All ER 162.

<sup>63</sup> *Furs Ltd v Tomkies* [1936] 54 CLR 583; Austin, *supra* note 26, 176-8.

<sup>64</sup> See Farrar, J.H. and Hannigan, B.M., *Farrar's Company Law*, (4th edition, 1998), 419; Brudney, V. and Clark, R.C., 'A new look at Corporate Opportunities', (1981) 94 *Harvard Law Review* 997, 1021.



wish to exploit and which the company, in general meeting, consented to the director exploiting.<sup>65</sup>

Along similar lines, it has been argued that where the opportunity is rejected *bona fide* by the board of directors on behalf of the company, the profit rule should not restrict a director from taking the opportunity for himself.

#### 4.2.2.2 *Where the corporate opportunity is rejected*

As mentioned above, the exception to the no-profit rule allows directors to exploit opportunities rejected by the company in general meeting. However, there are significant cases in which opportunities were rejected by the board of directors instead of the general meeting. The question which arises is whether rejection by the board would be sufficient to allow the director to exploit the corporate opportunity without liability.

A significant case which involved a finding that the board of directors had *bona fide* rejected the opportunity is *Peso Silver Mines Ltd v Cropper*.<sup>66</sup> The background facts to the case indicated that at that time the company had many mineral claims and strained financial resources. The acquisition of additional claims would have involved increased expenditure and the company neither needed nor wanted any more claims. As such, the claim in question was considered by the full board of directors and rejected before it was acquired by the respondent directors. The court based its decision on the hypothetical case stated by Lord Greene MR in the unreported judgment of the Court of Appeal in *Regal (Hastings)* as follows:-

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<sup>65</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136.

<sup>66</sup> (1966) 58 DLR (2d) 1.

"To say that the Company was entitled to claim the benefit of those shares would involve this proposition: Where a Board of Directors considers an investment which is offered to their company and bona fide comes to the conclusion that it is not an investment which their Company ought to make, any Director, after that Resolution is come to and bona fide come to, who chooses to put up the money for that investment himself must be treated as having done it on behalf of the Company, so that the Company can claim any profit that results to him from it. That is a proposition for which no particle of authority was cited; and goes, as it seems to me, far beyond anything that has ever been suggested as to the duty of directors, agents, or persons in a position of that kind."<sup>67</sup>

The Supreme Court of Canada found the facts of *Peso Silver Mines* to be in all material respects identical with those in the hypothetical case stated by Lord Greene MR, and concluded that the directors in question were not liable for utilising the opportunity which had been rejected by the board of directors.

A similar conclusion was reached by the Privy Council and the High Court of Australia in the Australian case of *Queensland Mines Ltd v Hudson*.<sup>68</sup> The company, Queensland Mines, was facing financial difficulties and lacked the resources to meet the obligations under a mining exploration licence which had recently been obtained. Mr Hudson, the director concerned, was then confronted with the difficult situation of immense obligations owed by him under the licence and no resources with which to fulfil such obligations. Mr Hudson then resigned as managing director of Queensland Mines so

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<sup>67</sup> *Ibid.* 8-9; Although Lord Greene MR was subsequently found by the House of Lords to be in error in his decision, his hypothetical case was thought to have been reserved by Lord Russell's judgment in the House of Lords. Lord Denning in *Boardman v Phipps* [1967] 2 AC 46 also appeared to have entertained a similar view.

<sup>68</sup> (1978) 52 ALJR 399.



that he could devote all his energy to this venture. Nonetheless, he never sought to hide anything from the company, and the board, fully informed and having renounced its interest in the licence, had assented to Mr Hudson 'going it alone'.<sup>69</sup>

Their Lordships reached the conclusion in *Queensland Mines* that there was 'no real, sensible possibility of conflict of interest between Mr Hudson, and the company'.<sup>70</sup> And as Mr Hudson was left on his own with the licences with the fully informed consent of the Queensland Mines board, they held that Mr Hudson was not liable to account for his profit made from the licences.

The Privy Council also considered the fact that the consent to Mr Hudson utilising the opportunity was given by the board of directors, rather than the shareholders of Queensland Mines. However, as both the shareholders were companies represented on the board of directors, the Privy Council held the view that both shareholders must have been aware of the situation. Consequently, the fact that there was no evidence of an express resolution by the shareholders approving Mr Hudson's utilisation of the opportunity was not regarded as an impediment to Mr Hudson's escape from liability.

Both the decisions in *Peso Silver Mines* and *Queensland Mines* appear to be at odds with decisions such as *Regal (Hastings) Ltd v Gulliver*<sup>71</sup>, *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*,<sup>72</sup> which assert that a fiduciary who makes a profit for himself requires the consent of the company in general meeting, as opposed to merely the board of directors, in order to avoid liability. It is submitted that the approach of the Privy Council in *Queensland Mines* appears to be reconcilable with the *Regal (Hastings)* line

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<sup>69</sup> The approach in *Queensland Mines* was affirmed in *Pacifica Shipping Co Ltd v Andersen* [1986] 2 NZLR 328 by way of *obiter dicta*.

<sup>70</sup> (1978) 52 ALJR 399, 401.

<sup>71</sup> [1942] 1 All ER 378.

<sup>72</sup> [1980] 2 MLJ 136.

of decisions on the grounds that both shareholders, who were the only shareholders of the company, were represented on the board of directors. As both shareholders were corporate bodies, and as such, acted through their representatives, the decision of the directors representing the shareholders arguably binds the shareholders based on the principle in *Re Duomatic Ltd*<sup>73</sup>, although this argument was not raised in the judgment of the Privy Council.

There are also a significant number of arguments as to why directors should not be allowed to exploit corporate opportunities merely because the opportunities were rejected by the board of directors. One of the major criticisms of allowing a director to take for himself opportunities which have been rejected by the board of directors is that it requires a determination by the court as to whether the board's rejection of the opportunity was *bona fide*.<sup>74</sup> This is a matter the courts have been reluctant to delve into on the grounds that the courts are incapable of ascertaining the truth of the matter.<sup>75</sup> Moreover, the evidence which would establish the financial ability or inability of the company to take the opportunity and other reasons for the rejection is solely within the control of those who will benefit personally if the company decides to reject the opportunity.<sup>76</sup> It is argued that anything less than an absolute rule that a director may not make a profit from his position will tempt the directors to be less than totally committed to obtaining the opportunity on behalf of the company.<sup>77</sup> Beck also queries whether it is possible for the courts to be entirely certain whether the disinterested directors are acting in the best interest of the company or of their fellow directors in rejecting the opportunity, and reasons that it is:-

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<sup>73</sup> [1969] 2 Ch 365; See *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* (1990) 3 ACSR 649, in which the *Duomatic* principle was applied.

<sup>74</sup> Farrar, *supra* note 64, 419.

<sup>75</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; Beck, *supra* note 57, 112.

<sup>76</sup> Farrar, *supra* note 64, 419.

<sup>77</sup> *Ibid.*



"safer for the courts to continue to make it clear to directors that if they are going to act in a situation in which their interest may conflict with their duty that they must seek the approval of fully informed shareholders."<sup>78</sup>

The decision in *Peso Silver Mines* has also been criticised on the conclusions drawn from the facts of the case. Beck argues that there was ample evidence that *Peso* was in exactly the same position as the *Regal* company, in that it wanted the property but could not finance the purchase.<sup>79</sup> Accordingly, despite the rejection of the opportunity, a conflict of interest existed in *Peso Silver Mines*, as in *Regal (Hastings)*. And where a conflict of interest exists, the fact that the fiduciary acted *bona fide* is irrelevant. Beck is also of the view that it is difficult to accept the court's finding of good faith rejection, in the light of the unsatisfactory evidence as to whether the full board of *Peso* considered the matter, and of the relatively short time thereafter that the director picked up the claims.<sup>80</sup>

The conclusion that can be drawn from the above is that the issue as to whether a director can utilise for his own gain a corporate opportunity which has been rejected by the board of directors is far from settled. This is more so in the light of the recent cases of *Guinness v Saunders*<sup>81</sup> and *A-G for Hong Kong v Reid*<sup>82</sup>, which herald the return to the position of the earlier cases that the profit rule must be strictly adhered to; the House of Lords in *Guinness v Saunders* taking the view that fiduciaries should not in any way be encouraged to put themselves in a position where their interests conflict with their fiduciary duties.

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<sup>78</sup> Beck goes further to suggest that the principle in *North Western Transportation Co v Beatty* (1887) 12 App Cas 589, that a director may use his votes as a shareholder to ratify a contract in which he is interested, should not apply to cases where the taking of a corporate opportunity is being sanctioned. He opines that the court should insist that directors' acts be approved by a majority of disinterested shareholders; Beck, *supra* note 57, 113.

Nonetheless, the remarks of Deane J in the Australian case of *Chan v Zacharia*<sup>83</sup> serve as a timely reminder of the need to allow flexibility in principles of equity in order to work justice in particular facts and changing circumstances.<sup>84</sup> Deane J opined that over-enthusiastic statements of broad, general principles of equity in terms which are inflexible may destroy that which equity intends to promote. As a result, equity may be converted into an instrument of hardship and injustice. Quoting Lord Selbourne LC in *Barnes v Addy*<sup>85</sup>, Deane J reiterated that:

*"There is no better mode of undermining the sound doctrines of equity that to make unreasonable and inequitable applications of them."*<sup>86</sup>

#### 4.3 A Corporate Opportunity Doctrine?

The above perusal of the cases relating to corporate opportunity reveals that there are varying approaches among Commonwealth jurisdictions. The issues faced by Commonwealth courts have similarly been encountered by the courts of the United States. In response, the courts and the legal fraternity of the United States have endeavoured to develop a corporate opportunity doctrine to deal with the specific controversies arising in the area of corporate opportunity. In particular, the American

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<sup>79</sup> Beck, *supra* note 57, 101.

<sup>80</sup> *Id.* 99.

<sup>81</sup> [1990] 2 AC 663.

<sup>82</sup> [1994] 1 AC 324.

<sup>83</sup> (1983-4)154 CLR 178.

<sup>84</sup> In that case, Deane J suggested that it may be arguable that the fiduciary should be permitted to obtain for himself benefits, which would usually be precluded by the no-profit rule, where it is plainly in the interests of the person to whom the fiduciary duty is owed for the fiduciary to obtain those benefits. He argued that the fiduciary should not be required to account for his profit in such situations, notwithstanding decisions such as *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 and *Phipps v Boardman* [1967] 2 AC 46. It is noted, however, that these statements were made by way of *obiter dicta*.

<sup>85</sup> (1874) LR 9 Ch App 244, 251.

<sup>86</sup> (1983-4)154 CLR 178, 205.



has contributed to the needed clarification in this core area of fiduciary obligation by defining the parameters of the directors' duty in this context.

#### 4.3.1 *The American Corporate Opportunity Doctrine*

Section 5.05 of the recommendations state the general rule on the taking of corporate opportunity as follows:-

*" (a) A director or senior executive may not take advantage of a corporate opportunity unless:-*

*(1) The director or senior executive first offers the corporate opportunity to the corporation and makes disclosure concerning the conflict of interest and the corporate opportunity;*

*(2) The corporate opportunity is rejected by the corporation; and*

*(3) Either:*

*(A) The rejection of the opportunity is fair to the corporation;*

*(B) The opportunity is rejected in advance, following such disclosure, by disinterested directors, (or, in the case of a senior executive who is not a director, by a disinterested superior,) in a manner that satisfies the standards of the business judgment rule; or*

*(C) The rejection is authorised in advance or ratified, following such disclosure, by disinterested shareholders, and the rejection is not equivalent to a waste of corporate assets.*

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<sup>87</sup> American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, (1994).

*(b) Definition of a Corporate Opportunity. For purposes of this Section, a corporate opportunity means:*

*(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:*

*(A) In connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or*

*(B) Through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or*

*(2) Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage."*

Some of the notable features of this rule are the fact that it distinguishes between directors who are also senior executives and directors who are not senior executives. The rule also permits a director to utilise an opportunity which has been rejected by the company. In addition, it sets the parameters as to when an opportunity is regarded as a 'corporate opportunity'. Each of these features will be further discussed below.

The American Law Institute's definition of 'corporate opportunity' distinguishes between directors who are executives and directors who are not executives. Both executive and non-executive directors are caught by the rule where the director becomes aware of the opportunity in connection with the performance of functions as a



director, or where the director should reasonably believe that the person offering the opportunity expects it to be offered to the corporation. Alternatively, both types of directors are caught by the rule when they become aware of the opportunity through the use of corporate information or property, if the resulting opportunity is one that the director should reasonably be expected to believe would be of interest to the corporation.

However, only executive directors are required to disclose opportunities to engage in a business activity which they know is closely related to a business in which the corporation is engaged or expects to engage.

Such a distinction between executive or full-time directors and non-executive or part-time directors, has been advocated in the United States by Professors Brudney and Clark.<sup>88</sup> Professors Brudney and Clark argue that a full-time or executive director should be prohibited from taking any other active business opportunities on the grounds that corporate executives are generally expected to devote their full working time to the affairs of the corporation.<sup>89</sup> Moreover, an executive director's role is similar to that of a trustee and shareholders should be protected from the tendency of officers of the company to divert corporate opportunity.<sup>90</sup> In contrast, a part-time director is generally not disentitled by reason of his commitment to the company from participating actively in other ventures. His limited role and commitment justifies allowing him more freedom for individual action and Professors Brudney and Clark argue that he should not be categorically denied participation in other ventures.<sup>91</sup> Rather, subjecting a part-time director to the limited restraint of a prohibition against the use of the corporation's

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<sup>88</sup> Brudney, *supra* note 64, 1042-5.

<sup>89</sup> *Id.* 1023-4.

<sup>90</sup> *Ibid.*

<sup>91</sup> *Id.* 1043.

advance or ratified by disinterested shareholders,<sup>97</sup> provided that the rejection is not equivalent to a waste of corporate assets.

This proposed rule prescribes a much clearer standard of behaviour than the 'appalling muddle' of Commonwealth cases.<sup>98</sup> Whilst the rejection of corporate opportunity by disinterested directors is more lax a standard than required by the *Regal (Hastings)* line of cases, it has been argued that the board of directors, excluding the affected directors, is an appropriate body for such assent, given that questions of business opportunity frequently involve matters of business judgment.<sup>99</sup> The authorisation or ratification of the rejection by disinterested shareholders goes a step further than *Regal (Hastings)*, which requires merely the approval of shareholders.<sup>100</sup>

The proposed rule also defines the parameters of a 'corporate opportunity'. Section 5.05(b)(2) applies the approach known as the 'expanded line of business test' which is similar to the approach adopted in *Industrial Development Consultants v Cooley*.<sup>101</sup> In

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<sup>97</sup> See Sections 1.16 and 1.23 of the American Law Institute's recommendations. A shareholder is regarded as being interested in a transaction if the shareholder or an associate of the shareholder is also an interested director with respect to the transaction; American Law Institute, *supra* note 87, 20-2, 25-9.

<sup>98</sup> See Austin, *supra* note 26, 183. Nonetheless, it is noted that the rules provide for the rejection to be fair, *or* to be by disinterested directors or ratified or authorised by disinterested shareholders in the manner specified. It is submitted that this leaves ambiguity as to whether such 'fair rejection' should be by disinterested directors or shareholders and by what standards a rejection should be judged as fair or unfair.

<sup>99</sup> Austin, *supra* note 26, 184; Beck, however, notes that it may never be entirely clear whether disinterested directors are acting in the best interests of the company or of their fellow directors in rejecting a corporate opportunity; Beck, *supra* note 57, 113. In contrast, Professors Brudney and Clark argue that in public corporations, the substantive and procedural defects of corporate consent make it a poor filter for restraining improper diversion of corporate opportunities, and conclude that the absence of any compelling reasons to permit 'proper' diversions emphasises the pointlessness of incurring such a cost; Brudney, *supra* note 64, 1034-5.

<sup>100</sup> According to *North-West Transportation v Beatty* (1887) 12 App Cas 589, the affected directors would have the right to vote as shareholders notwithstanding their interest in the transaction. Professor Austin and Beck both support the proposition that the affected directors should not vote as shareholders; Austin, *supra* note 26, 184; Beck, *supra* note 57, 113; However, Berger recognises that the requirement of rejection may be manipulated by others in the company to extract some concession from a director; Berger, M., 'The Corporate Opportunity Doctrine and Outside Business Interests', (1989) 56 *University of Chicago Law Review* 827, 851. See also Brudney, *supra* note 64, 1032-5.

<sup>101</sup> [1972] 2 All ER 162; See Austin, *supra* note 26, 160.



essence, the expanded line of business includes opportunities which are closely associated with the existing and prospective activities of the corporation, including areas into which the corporation might naturally or easily expand.<sup>102</sup> Such an approach appears to be favoured over the broad factor-based evaluation of conduct such as was adopted in *Canadian Aero Service Ltd v O'Malley*<sup>103</sup>, one of the reasons being the need for certainty and predictability in the commercial arena.<sup>104</sup> Although it is conceded that each of these formulations of the corporate opportunity doctrine involves a degree of uncertainty,<sup>105</sup> the expanded line of business approach has the advantage of greater certainty as it utilises concepts which are indicative of the matters relevant to liability and sets a standard of behaviour.<sup>106</sup>

The corporate opportunity doctrine developed by the United States provides us the benefit of having confronted issues which have yet to be contested in our courts. Although there remains some disagreement as to various aspects of the doctrine, we can extract some guidance from the experience of the United States. The recommendations of the American Law Institute<sup>107</sup> are of particular value in this regard. Whilst the recommendations have been criticised as imposing a heavy burden on directors,<sup>108</sup>

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<sup>102</sup> Note, (1961) 74 *Harvard Law Review* 765, 768.

<sup>103</sup> (1973) 40 DLR (3d) 371; See Beck, S.M., 'The Quickening of Fiduciary Obligation: Canadian Aero Services v O'Malley', (1975) 53 *Can Bar Rev* 771, 782-3.

<sup>104</sup> Austin, *supra* note 26, 161.

<sup>105</sup> Austin, *supra* note 26, 161; Beck, *supra* note 103, 782-3; Brudney, *supra* note 64, 1012-3; Professors Brudney and Clark observe that the process of identifying what is within the company's line of business involves empirical examination of comparable phenomena in similar businesses, which will inevitably permit some random or subjectively biased results. They suggest that the opportunity should be presumed to be within the company's line of business and the onus should be on the diverter to prove the contrary.

<sup>106</sup> Austin, *supra* note 26, 161-5;

<sup>107</sup> American Law Institute, *supra* note 87.

<sup>108</sup> Berger, *supra* note 100, 863. In contrast, O'Connor observes that the language of the rule avoids the traditional use of vigorous moral language and fails to convey the spirit of the high standard of fidelity owed by directors, thereby weakening the socialising force of corporate law; O'Connor, M.A., 'How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's *Principles of Corporate Governance*', (1993) 61 *The George Washington Law Review* 954.

Norris JA's remark functions as an apt reminder of the need to protect the company from abuse by its fiduciaries:-

*"With great respect, it seems to me that the complexities of modern business are a very good reason why the rule should be enforced strictly in order that such complexities may not be used as a smoke-screen or a shield behind which fraud might be perpetuated."*<sup>109</sup>

It is unlikely that Commonwealth law will be able to move from its present state of chaos to such a structure by the process of judicial decision.<sup>110</sup> Legislative intervention may be necessary to enable the courts to 'wipe the slate clean and start building again'.<sup>111</sup>

#### 4.4 Conclusion

It is apparent from the examination of case law earlier in this chapter that the Malaysian case law, as with the Commonwealth case law, relating to the no-profit rule is in a fairly unsettled and disorderly state. In addition, the Malaysian legislative provision, namely Section 132(2) of the Companies Act, 1965 (Act 125) provides little clarification to the situation.

Section 132(2) deals with information acquired by a director but does not include corporate opportunity and corporate property. Arguably, corporate opportunity may be the result of acquiring corporate information. Nonetheless, it has been suggested that

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<sup>109</sup> *Peso Silver Mines Ltd v Cropper* (1966) 56 DLR (2d) 117, 154-5.

<sup>110</sup> Austin, *supra* note 26, 184.

<sup>111</sup> *Ibid.*



the same should be clearly specified in legislation.<sup>112</sup> The Section also does not define what the phrase 'improper use' of information entails. It also does not address the possibility of rejection of opportunities by the company. It is submitted that directors should be allowed to use corporate information or opportunity where the consent of the general meeting has been obtained, along the lines of the equitable no-profit rule. Similarly, it has been suggested that the Section should require full disclosure of material facts of the transaction and the conflict of interest, if any.<sup>113</sup>

Section 132(2) also fails to deal specifically with issues discussed Section 4.2 above, such as the uncertainty in the formulation and ambit of the no-profit rule and the connecting link between profit and the fiduciary office. Unless such issues are addressed, the confusing state of the Malaysian and Commonwealth case law is likely to remain as a thorn in the flesh of corporate players. And where such uncertainty in the law prevails, injustice is likely to result even where conscientious efforts to abide by the law have been made.

The inadequacies of the current statutory regime have been acknowledged by the Finance Committee on Corporate Governance in a recent report.<sup>114</sup> The Finance Committee on Corporate Governance has recognised a need to clarify the responsibilities of directors such that they will be readily understood, envisaging that in some circumstances it may involve codification of directors' duties. A number of suggestions were made, including two pertinent recommendations which relate to corporate opportunity taken by directors. The first was a suggestion that the authorisation of disinterested directors should be obtained in respect of such transactions, after full disclosure of the conflict of interest and the material facts of the

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<sup>112</sup> Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 124.

<sup>113</sup> *Ibid.*

transaction.<sup>115</sup> Secondly, the Finance Committee on Corporate Governance recommended that even where the transaction has been approved by disinterested directors, the court should have the ability to enquire as to the fairness of the transaction at all times.<sup>116</sup> This addresses issues pertinent to the Malaysian corporate scene in which it is common for so-called independent members of the board of directors to be friends and invitees of a controlling shareholder.<sup>117</sup>

These recommendations generally parallel the position taken by the American Law Institute as well as legal scholars.<sup>118</sup> Another notable point is that the recommendations for reform are primarily targeted at public listed companies.<sup>119</sup> This, too, is in line with the views of Professors Brudney and Clark that stricter rules are required to regulate the behaviour of directors of public companies.<sup>120</sup> They reason that this is necessary due to the limited capacities of the shareholders of public companies to select and monitor fiduciaries to whom they have entrusted their capital.<sup>121</sup>

Apart from the need for clarification of the no-profit rule, the enforcement of the rule is also beset by practical difficulties and complications. One of the difficulties facing shareholders of the company has its source in the separation of ownership and control of the company. As shareholders are frequently not involved in the day-to-day

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<sup>114</sup> *Id.* 123.

<sup>115</sup> *Id.* 125. The Finance Committee on Corporate Governance also recommended that the disinterested directors should be informed in respect of the matter to the extent that such directors reasonably believe to be appropriate in the circumstances. In addition, the disinterested directors should rationally believe that the decision to allow the taking of corporate opportunity is in the best interests of the company.

<sup>116</sup> *Ibid.*

<sup>117</sup> *Ibid.*

<sup>118</sup> Austin, *supra* note 26, 184; Beck, *supra* note 57, 113. Note, however, that Professors Brudney and Clark take a different view. They reject the exploitation of corporate opportunity by directors even with the consent of fellow directors on the grounds that the shareholders of public companies have limited capacities to select and monitor fiduciaries. Brudney, *supra* note 64, 1034-5.

<sup>119</sup> The issue of whether stricter rules should be imposed on public companies than on private companies is discussed in greater detail in Chapter 5.

<sup>120</sup> Brudney, *supra* note 64, 1002-6.



management of the company, they may be unaware of the taking of profit by directors, unless the same is disclosed. Such information is likely not to be readily available to those not involved in running the company. As such, shareholders would frequently be dependent on directors' transparency in disclosing these details. And in situations where there is failure to make such disclosure, the shareholders may remain ignorant of such breaches of directors' duties.

A further complication arises from the increased complications in the corporate structures of recent times. Large conglomerates, in particular, are often found to have complicated shareholding structures. Directors may at times have a stake in the subsidiary companies. Consequently, in dealings between related companies, the directors would at times make an indirect profit through their shareholding in one of the companies involved in the transaction. Similarly, a director may hold shares in a company which enters into a transaction with the company of which he is a director. It is arguable that a strict interpretation of the no-profit rule would require the directors to account for any profit made. However, in an era where it is not uncommon for a person to hold shares in a large number of companies, requiring the director to account for profit made indirectly by virtue of his shareholding in a company which enters into such a transaction would open up the floodgates to claims for an account for profit. In addition, directors are likely to be significantly restricted in the transactions they enter into on behalf of the company, in order to avoid liability to themselves.

Some of these recommendations, particularly those highlighted in the Finance Committee's Report on Corporate Governance, are currently being studied with a view to implementation of the same. The process is likely to be fraught with challenges, given the delicate balance which needs to be maintained between investor protection on

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<sup>121</sup> *Ibid.*

the one hand, and excessive regulation which may stifle corporate activity on the other hand. In reformulating the rules applicable to corporate opportunity, it should be borne in mind that the rules of other jurisdictions may need to be recast so as to be contextualised to the needs of the corporate situation in Malaysia.<sup>122</sup> The economic crash of 1997 was a timely reminder of the need to strengthen investor protection in Malaysian capital markets.<sup>123</sup> And the same, once again, reinforces the importance of the fiduciary principle which requires high standards of fidelity of directors in whom the confidence of the investors is reposed, protecting investors from abuse by the fiduciaries.

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<sup>122</sup> See Koh, P.T.N., 'Company Ownership Disclosure and Liabilities in Malaysia', [1992] 2 MLJ li, lxviii.

<sup>123</sup> Ali Abdul Kadir, 'The Corporate Governance Trend in Malaysia: February 1999 Finance Committee Report on Corporate Governance', Corporate Governance Conference for Nominee Directors of PNB, Kuala Lumpur 20 August 1999.



## CHAPTER 5 - STATUTORY REGULATION OF SPECIFIC TRANSACTIONS AND ARRANGEMENTS<sup>1</sup>

The fiduciary duties imposed on directors by equity have been supplemented by statutory provisions. These provisions are contained in the Companies Act, 1965 (Act 125). In Chapter 3, Section 131 of the Companies Act, 1965 (Act 125), which requires disclosure of conflicts of interest, was examined. In addition, in Chapter 4, it was noted that the rule that a director should not make a profit from information acquired by virtue of his position has been incorporated into the Companies Act, 1965 (Act 125). Apart from the aforesaid provisions, a number of specific transactions and arrangements involving self-dealing by directors are regulated by the Companies Act, 1965 (Act 125).

The legislative purpose behind these statutory provisions is to reinforce the general fiduciary duties of directors.<sup>2</sup> Although one cannot prevent dishonesty by legislation, these provisions are nonetheless intended to minimise the possibility of shareholders' investments being eroded by directors' self-dealing.<sup>3</sup> This is accomplished firstly, by prohibiting certain director-related transactions unless the approval of the general meeting is obtained. Secondly, specific transactions are prohibited absolutely. Thirdly, disclosure is required of specific interests. Provision is also made for various civil

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<sup>1</sup> Parts of this chapter have been published by the author in a paper entitled 'Directors' Self-Dealing and the Malaysian Companies Act, 1965'. This paper was published at the 11<sup>th</sup> Corporate Law Teachers' Association Conference, Melbourne, Australia 11-13<sup>th</sup> February 2001. The consent of Professor Dato' P. Balan to the publication of the said paper was duly obtained prior to such publication.

<sup>2</sup> Loh, S.C., *Corporate Powers: Controls, Remedies and Decision-making*, (1996), 273-4.

<sup>3</sup> Parliamentary Debates, Dewan Rakyat, Official Report, Eighth Parliament, Second Session, 20 July, 1992, 57-8; Koh, P.T.N., 'Principles, Practice and Prospects of Corporate Governance: The Malaysian Legal Framework', [1994] 3 *MLJ* ix, x.

consequences and remedies, as well as criminal penalties, in the event of infringement of the statutory provisions.<sup>4</sup>

Most of the provisions of the Companies Act, 1965 (Act 125) which regulate transactions involving self-dealing by directors are based on provisions which are, or which were at some time, found in the companies legislation of Australia and the United Kingdom. Nonetheless, these provisions of the Companies Act, 1965 (Act 125) bear a greater resemblance to older provisions of the companies legislation of these jurisdictions. They do not incorporate some of the more recent amendments to the companies legislation of Australia and the United Kingdom.

The first part of this chapter deals with the sections of the Companies Act, 1965 (Act 125) which prohibit specific transactions and arrangements which involve an element of self-dealing by directors. In the second part of this chapter, the statutory provisions requiring disclosure of directors' interests and dealings with the company will be examined. Lastly, developments in statutory provisions which regulate self-dealing by directors in Australia and the United Kingdom will be considered.

## **5.1 Prohibited Transactions and Arrangements**

The Companies Act, 1965 (Act 125) sets out a number of categories of transactions and arrangements which are prohibited. These are generally regarded as transactions and arrangements which involve or potentially involve self-dealing. Among these transactions and arrangements are loans to directors and persons connected with directors. These are dealt with in Sections 133 and 133A. Substantial property transactions involving directors are regulated by Section 132E. In addition, Section

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<sup>4</sup> Loh, *supra* note 1, 273-4.



132G prohibits transactions involving substantial shareholders and directors which fall within the ambit of Section 132G. Some of these transactions and arrangements are prohibited absolutely. Others are made subject to the approval of the company in general meeting.

The effect of requiring the approval of shareholders in respect of these transactions and arrangements is to reduce the power of directors over matters which are likely to involve self-dealing, shifting the power to shareholders instead. This addresses the issue of the increased potential for self-dealing resulting from the separation between the ownership and control of companies. By shifting the authority to approve such transactions from directors to shareholders, the control over such transactions is restored to the owners of the company. This arguably has the effect of reducing the potential for self-dealing by directors who would otherwise have control over the company's assets relatively free from the scrutiny of shareholders.

These statutory provisions recognise that self-dealing by directors may at times involve persons other than directors. Instead of dealing directly with the company, a director may wish to structure his dealings such that he deals indirectly with the company through nominees. Accordingly, Sections 133A, 132E and 132G also deal with arrangements and transactions involving persons deemed to be connected with directors.

Section 122A of the Companies Act, 1965 (Act 125) names four categories of persons who are deemed to be connected with a director. They are, firstly, a member of that director's family, which includes the director's spouse, parent, child or sibling. Secondly, a body corporate which is associated with that director is deemed to be

connected with him.<sup>5</sup> Also included is a trustee of a trust under which that director or a member of his family is a beneficiary. Fourthly, a partner of that director is deemed to be a person connected with that director. Similarly, a partner of a person connected with that director is also a person connected with that director.

### **5.1.1 Loans to Directors and Persons Connected with Directors - Sections 133 and 133A**

#### **5.1.1.1 Section 133**

Section 133<sup>6</sup> prohibits companies<sup>7</sup> from making a loan to a director of the company or of a related company. The word 'loan' is not defined by the Companies Act, 1965 (Act 125). In essence, a loan of money is the payment of a sum of money on condition that an equivalent amount would be repaid at a future time.<sup>8</sup> In addition, the Section also prohibits the entry into any guarantee and the provision of any security by the company, in connection with a loan made to a director of the company or a director of a related

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<sup>5</sup> Section 122A(3) sets out a number of situations in which a body corporate is associated with a director. This includes a body corporate that is accustomed to act in accordance with the director's instructions and a body corporate in which the director has a controlling interest. In addition, it includes a body corporate of which he controls the exercise of fifteen per centum or more of the votes.

<sup>6</sup> Section 133(1) states that:-

*"A company (other than an exempt private company) shall not make a loan to a director of the company or of a company which by virtue of section 6 is deemed to be related to that company, or enter into any guarantee or provide any security in connection with a loan made to such a director by any other person but nothing in this section shall apply -*

- (a) subject to subsection (2), to anything done to provide such a director with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company;*

- (b) to anything done to provide such a director who is engaged in the full-time employment of the company or its holding company, as the case may be, with funds to meet expenditure incurred or to be incurred by him in purchasing or otherwise acquiring a home; or*

- (c) to any loan made to such a director who is engaged in the full-time employment of the company or its holding company, as the case may be, where the company has at a general meeting approved of a scheme for the making of loans to employees of the company and the loan is in accordance with that scheme."*

<sup>7</sup> Exempt private companies are exempted from the prohibitions of Section 133.

<sup>8</sup> *Re Securitibank Ltd (No. 2)*, per Richardson J [1978] 2 NZLR 136, 137; applied by Ormiston J in *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd & Ors* (1991) 9 ACLC 324, 357.



company. It would appear that in each of the aforesaid categories, the substance of the transaction would be more important than the form or label given to it by the parties.<sup>9</sup>

Certain exceptions to the prohibitions are set out in Section 133(1). In particular, the Section permits the company to provide directors with funds to meet expenditure incurred or to be incurred for the purpose of the company. The Section also permits the company to provide funds to the director to enable the director to properly perform his duties as an officer of the company. In addition, the Section allows companies to provide full-time directors with funds for acquiring a home. Nevertheless, the approval of the company at a general meeting must be obtained in respect of these excepted transactions in accordance with Section 133(2). Otherwise, the loan must be repaid, or the liability under the guarantee or security discharged, within the time stipulated in Section 133(2). In addition to the excepted transactions mentioned above, companies may also grant to directors any loan in accordance with an employee loan scheme approved by the company in general meeting.

As for the consequences of contravention of Section 133, Section 133(4) clearly provides that any director who authorises the prohibited transaction shall be guilty of an offence against the Companies Act, 1965 (Act 125). The wording of the Section appears to indicate that a director would be strictly liable, without recourse to any defence, for authorising such a transaction. In contrast, the equivalent statutory provisions in Australia and the United Kingdom stipulate that it would be a defence if the director proves that he had no knowledge of the relevant circumstances constituting

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<sup>9</sup> *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] MLJ 74. The facts of this case involved post-dated cheques which allegedly amounted to a money-lending transaction. Lord Devlin remarked that in such situations the court should look at the nature of the transaction. And if the court comes to the conclusion that the form of the transaction is only a sham and that what the parties really agreed on was a loan which they disguised, then the court will call it by its real name and act accordingly.

the contravention at the time the transaction was entered into.<sup>10</sup> It is suggested that such a defence would be fairer to a director who may be unaware of the contravention due to no fault of his own. Where the director who benefits from the transaction fails to disclose the facts leading to the contravention, the fault would appear to lie with that director, rather than the other directors.

Where Section 133(1) is contravened, 133(3) further stipulates that the directors who authorise the making of the transaction shall be jointly and severally liable to indemnify the company against any loss arising from the transaction.<sup>11</sup> It is worth noting that the Section does not specify that the obligation to indemnify the company arises whenever there is a contravention of the Section. Rather, it is worded such that the obligation to indemnify the company arises where the company's approval is not given. This appears to be a reference to the excepted transactions set out in Section 133(1) which require the approval of the general meeting.<sup>12</sup> Hence, it appears that the obligation to indemnify the company does not extend to other transactions made in contravention of Section 133(1). Nevertheless, from the viewpoint of the company, an indemnity by the directors would be equally desirable in relation to transactions entered into in blatant contravention of the Section.<sup>13</sup>

Apart from stipulating that the directors shall be made liable on contravention of Section 133, the Section also provides for a restitutionary remedy for the company.

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<sup>10</sup> Section 234 of the Corporations Law (Australia) and Sections 341 and 342 of the Companies Act 1985 (UK). Section 234 of the Corporations Law (Australia) has since been repealed and replaced by Chapter 2E of the Corporations Law (Australia).

<sup>11</sup> As above, it is similarly suggested that a director should have recourse to the defence that he did not have any knowledge of the circumstances leading to the contravention at the time of the transaction.

<sup>12</sup> Section 133(2).

<sup>13</sup> An indemnity which covers transactions entered into in contravention of the section, and not merely where the company's approval is not given is found in Section 234(5) of the Corporations Law (Australia) and Section 341 of the Companies Act 1985 (UK). It is noted that Section 234(5) of the Corporations Law (Australia) has since been repealed and replaced by Chapter 2E of the Corporations Law (Australia).



Section 133(5) allows the company to recover the amount of any loan or amount for which it becomes liable under any guarantee or security given in contravention of Section 133.

#### *5.1.1.2 Section 133A*

Section 133A<sup>14</sup> is similar to Section 133, except that instead of directors, it deals with persons connected with a director of the company or of its holding company. Section 133A(1) prohibits the making of a loan and the giving of any guarantee or security for the benefit of any person connected with a director of the company or of its holding company.

An exception to the prohibition would be a loan made, or a guarantee or security provided, for the benefit of a related company.<sup>15</sup> In addition, companies whose ordinary business includes the lending of money are excepted from the prohibition in Section 133A(1), as long as the loan is made or the guarantee or security is given in the ordinary course of business.<sup>16</sup> A company may also make a loan to a person connected with a director, if the director is engaged in full-time employment with the company or its related company. As in Section 133, such a loan must be for the purpose of acquiring a home or in accordance with an employee loan scheme approved by the shareholders.<sup>17</sup>

In the event of a contravention of Section 133A, subsection (4) stipulates that any director who authorises the transaction would be guilty of an offence. However,

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<sup>14</sup> Section 133A was inserted into the Companies Act, 1965 (Act 125) by the Companies (Amendment) Act, 1986 (Act 657), s11.

<sup>15</sup> Section 133A(2)(a).

<sup>16</sup> Section 133A(2)(b).

<sup>17</sup> Section 133A(2)(c).

Section 133A does not provide for any indemnity by such directors.<sup>18</sup> Nonetheless, as in Section 133, a company is allowed to recover the amount of any loan, guarantee or security provided in contravention of Section 133A.<sup>19</sup>

#### *5.1.1.3 The validity of a contract made in breach of Section 133*

A controversial issue concerning Section 133 is whether a contract entered into in contravention of Section 133 is valid. This issue would similarly apply to a contract entered into in contravention of Section 133A. The cases in which this issue has arisen have, however, only concerned Section 133.

It is clear that the company may recover the amount of any loan or amount for which it becomes liable under any guarantee entered into or security given contrary to Section 133.<sup>20</sup> Nevertheless, the Section does not expressly state whether a contract which contravenes Section 133 is valid.

This issue of the validity of such a contract was canvassed in a series of cases beginning with the case of *Che Wan Development Sdn Bhd v Co-operative Central Bank Bhd*.<sup>21</sup> In *Che Wan*, N. H. Chan J (as he then was) found that a charge transaction entered into in contravention of Section 133 was illegal and hence, void and unenforceable. In considering the applicable law, N. H. Chan J noted that the intention behind the statutory prohibition on loans to directors is the protection of the company's assets from being depleted through misuse by its directors. Having considered Section 133(5), he took the view that the subsection does not affect any defence of illegality available to the company. Accordingly, where Section 133 is contravened, the

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<sup>18</sup> As with Section 133, it is submitted that a director should be required to indemnify the company in the event that Section 133A is contravened. This should be subject to the defence that he did not have any knowledge of the circumstances.

<sup>19</sup> Section 133A(3).

<sup>20</sup> Section 133(5).

<sup>21</sup> [1990] 2 MLJ 365.



company would be able to rely on the defence of illegality to avoid transactions, and prevent its assets from being depleted.

The issue has not been regarded as settled by the decision in *Che Wan*, as various subsequent judicial decisions indicate. For instance, the court in the case of *Co-operative Central Bank Bhd v Syarikat Bukit Tinggi*<sup>22</sup> declined to follow *Che Wan*. Nevertheless, in *Co-operative Central Bank Ltd v Feyen Development Sdn Bhd*,<sup>23</sup> the decision in *Che Wan* was followed by the High Court.

The issue came before the Federal Court on appeal in the case of *Co-operative Central Bank Ltd v Feyen Development Sdn Bhd*.<sup>24</sup> In *Feyen*, the Federal Court overruled the decision in *Che Wan*. The facts of *Feyen* involved charges which were given by the company as security for a loan. The borrower was said to be a director of the company. However, it was the company which ultimately received the loan. Thus, there was no question of the assets of the chargor company being depleted through misuse. Rather, the position was quite the opposite. The chargor sought to get back its property free of the charges as well as to avoid repayment of the loan.

The Federal Court expressed its unwillingness to lend its aid to the chargor company in taking advantage of its own wrong. Edgar Joseph FCJ took the view that:-

*"to admit the defence of illegality ... would ... provide 'a windfall gain' to the chargor company and others in a similar position. In consequence, such a result would impose substantial hardship upon the chargee society."*<sup>25</sup>

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<sup>22</sup> [1991] 1 CLJ 590.

<sup>23</sup> [1994] 1 MLJ 75.

<sup>24</sup> [1995] 3 MLJ 313.

<sup>25</sup> *Id.* 329.

In delivering the judgment of the Federal Court, Edgar Joseph FCJ found that Section 133(5) had in effect impliedly validated all transactions prohibited by subsection (1). Edgar Joseph FCJ also took into account the recent trend in common law jurisdictions against finding contracts void due to a contravention of legislative provisions. His Lordship concluded that no civil consequences flowed from the breach of Section 133(1), and consequently, no voidness or unenforceability attached to the loan or the charge transactions.

Notwithstanding that *Feyen* was a decision of the Federal Court, instead of settling the issue, it appears to have attracted much controversy. The decision has been lauded,<sup>26</sup> criticised,<sup>27</sup> and in *Harta Empat Sdn Bhd v Koperasi Rakyat Bhd*,<sup>28</sup> was brushed aside as *obiter* by the Court of Appeal. The Court of Appeal's treatment of *Feyen* in the case of *Harta Empat* invited a stinging rebuke by the Federal Court, that the Court of Appeal 'flew in the face' of established principles of precedent.<sup>29</sup>

With respect, it is noted that neither of the judgments in the above cases appear to have taken into account relevant provisions of the Contracts Act, 1950 (Act 136). In particular, Section 24 of the Contracts Act, 1950 (Act 136) in effect provides that where the object of an agreement is forbidden by law, the agreement is void. This provision was considered by the Supreme Court in *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd*.<sup>30</sup> In *Chung Khiaw Bank*, one of the issues before the court was whether an agreement which was made in contravention of the prohibition in Section 67 of the Companies Act, 1965 (Act 125) was valid. It was argued before the Supreme Court that the trend in common law jurisdictions that courts should be slow in striking down

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<sup>26</sup> *Datuk Tan Leng Teck v Sarjana Sdn Bhd* [1997] 4 MLJ 329.

<sup>27</sup> Sangha, B., 'Co-operative Central Bank Ltd v Feyen Development Sdn Bhd - A Step in the Wrong Direction?', [1996] 2 MLJ lxxxi.

<sup>28</sup> [1997] 1 MLJ 381.

<sup>29</sup> [1997] 2 MLJ 829, 837.



illegal contracts should be followed. This same argument that was put before the Federal Court in *Feyen*. However, the Supreme Court held in *Chung Khiaw Bank* that Section 24 of the Contracts Act, 1950 (Act 136) overrides the common law. Hence, according to this view, a contract entered into in contravention of Section 133 would be void.

It is submitted that even if Section 24 of the Contracts Act, 1950 (Act 136) had been applied in *Che Wan*, the court would probably have reached the same conclusion. The court found the contract void in *Che Wan*, although Section 24 of the Contracts Act, 1950 (Act 136) was not discussed in the judgement. The decision in *Feyen*, however, is quite the opposite from the outcome of Section 24 of the Contracts Act, 1950 (Act 136). With respect, it is submitted that the Federal Court erred in its decision in *Feyen*. Firstly, one of the grounds for the Federal Court's decision was the trend in the common law. The common law would not be applicable, in view of the overriding statutory provision in Section 24 of the Contracts Act, 1950 (Act 136).<sup>31</sup>

In addition, the wording of Section 133(5) is similar to the wording of Section 67(6) of the Companies Act, 1965 (Act 125) at the time the decision in *Chung Khiaw Bank* was made.<sup>32</sup> In *Chung Khiaw Bank* the Supreme Court noted that the object of Section 67(6) was to protect the company and no one else. The Section was designed to prevent the assets of the company from being misused. As such, the Supreme Court did not accept the contention that the company's liability to third parties remained unaffected

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<sup>30</sup> [1990] 1 MLJ 356.

<sup>31</sup> *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd* [1990] 1 MLJ 356.

<sup>32</sup> Prior to the decision in *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd* [1990] 1 MLJ 356, Section 67(6) of the Companies Act, 1965 (Act 125) allowed *the company* to recover *inter alia* the amount of any loan made in contravention of the Section. Subsequently, Section 67(6) of the Companies Act, 1965 (Act 125) was amended by Section 13 of the Companies (Amendment) (No. 2) Act, 1992 (Act A836). The amendment expressly permits the company as well as *any person* to recover such amounts. However, as Section 133(5) has remained unchanged, it is submitted that the reasoning in *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd* [1990] 1 MLJ 356 is applicable to Section 133(5).

by the prohibition contained in the Section. Similarly, it is argued that the object of Section 133 would be to protect the company's assets from being depleted through misuse. In *Che Wan*, N. H. Chan J adopted a similar line of reasoning. By concluding that the company would be able to rely on the defence of illegality to avoid transactions, N. H. Chan J reasoned that the company would then be able to prevent its assets from being depleted. In contrast, the finding in *Feyen* that Section 133(5) had in effect impliedly validated all transactions prohibited by subsection (1) would result in the company being unable to prevent its assets from being depleted. This result would appear to be contrary to the object of Section 133.

Thirdly, from the judgement in *Feyen*, it appears that one of the major considerations which led the Federal Court to its decision was the court's reluctance to lend its aid to the company's efforts to take advantage of its own wrong. With respect, it is submitted that even if the transaction had been found to be void, Section 66 of the Contracts Act, 1950 (Act 136) may have operated to prevent the company from taking advantage of its own wrong. Section 66 of the Contracts Act, 1950 (Act 136) stipulates that when an agreement is discovered to be void or becomes void, any person who has received any advantage under the agreement is bound to restore it or to make compensation for it. However, this remedy would only be available to a party who did not know of the illegality from the beginning of the transaction.<sup>33</sup>

As such, in *Feyen*, Section 66 of the Contracts Act, 1950 (Act 136) would have operated to prevent the company from carrying out its plan to take advantage of its own wrong, unless the lender was aware of such illegality from the beginning. From the facts set out in the judgment, it is not clear whether the lender was aware of the illegality of the transaction. If the lender had not been aware of the illegality, it would



be arguable that the Section would have required the company to repay the loan in order to get back its property free of the charges.

The decision in *Feyen* has also been criticised by Sangha. In particular, she argues that the Federal Court's decision that Section 133(5) impliedly validated all transactions prohibited by Section 133(1) was based on a fundamental misinterpretation of the legislation.<sup>34</sup>

The conflicting decisions on the issue reflect the limitations of the judiciary in attempting to resolve the issue. As *Feyen* is a decision of the Federal Court, this further suggests that the uncertainty surrounding this issue would be more effectively resolved by legislative intervention.<sup>35</sup>

It is noted that subsequent to the decision in *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd*,<sup>36</sup> Section 67(6) of the Companies Act, 1965 (Act 125) was amended to provide for recovery of loans or any other sums by any person.<sup>37</sup> The reason for the amendment was to prevent companies from taking advantage of the technicalities of Section 67 so as to avoid their contractual obligations.<sup>38</sup> This is similar to the concerns expressed by the Federal Court in *Feyen*. Such legislative action is likely to be more effective than judicial decisions in resolving the uncertainty of the issue of the validity of contracts which contravene Sections 133 or 133A.

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<sup>33</sup> *Ahmad bin Udoh v Ng Aik Chong* [1970] 1 MLJ 82; *Yeep Mooi v Chu Chin Chua* [1981] 1 MLJ 14.

<sup>34</sup> Sangha, *supra* note 27, xc-xcv.

<sup>35</sup> *Ibid.*

<sup>36</sup> [1990] 1 MLJ 356.

<sup>37</sup> Companies (Amendment) (No. 2) Act, 1992 (Act A836).

<sup>38</sup> Parliamentary Debates, Dewan Rakyat, Official Report, Eighth Parliament, Second Session, 20 July, 1992, 46-7.

However, it should also be borne in mind that an amendment to the effect of the amendment made to Section 67(6), allows any person to recover a loan made in contravention of the Section. This may have the undesirable result of permitting the company's assets to be depleted. Ironically, this, in turn, would appear to be contrary to the purposes of Sections 133 and 133A.

The debate concerning the validity of contracts made in contravention of Section 133, as reflected by the case law, appears to be centred mainly around the issue of who should bear the loss caused by such a transaction. Similarly, the legislative amendment discussed above also addresses similar concerns. Essentially, this question, as to who should bear the loss resulting from transactions in breach of Sections 133 or 133A, would seem to be a question of policy. It would seem appropriate for such a question to be dealt with by Parliament.

### **5.1.2 Substantial Property Transactions - Section 132E**

#### **5.1.2.1 The prohibition**

Section 132E(1)<sup>39</sup> prohibits a company from entering into any arrangement or transaction to acquire any non-cash assets of the requisite value from a director of the company.<sup>40</sup> It similarly prohibits the disposal by the company of any non-cash assets of

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<sup>39</sup> Section 132E(1) provides that:-

*"Subject to Section 132F, a company shall not enter into any arrangement or transaction with a director of the company or its holding company or with a person connected with such a director to acquire from or dispose to such a director or person any non-cash assets of the requisite value unless the arrangement or transaction is first approved by a resolution of the company in general meeting and also, if the director or connected person is a director of its holding company or person connected with such a director, by a resolution of the holding company in general meeting."*

Section 132E was inserted into the Companies Act, 1965 (Act 125) by the Companies (Amendment) Act, 1986 (Act 657), s10, and subsequently amended by the Companies (Amendment) Act, 1992 (Act A836).

<sup>40</sup> Section 132E(1) is *pari materia* to Section 320(1) of the Companies Act, 1985 (UK). Section 320(1) of the Companies Act, 1985 (UK) reads as follows:-

*"With the exceptions provided by the section next following, a company shall not enter into an arrangement-*



the requisite value to a director. Apart from prohibiting such transactions and arrangements with directors, the subsection also prohibits such transactions and arrangements made with a person connected with a director. In addition, the prohibition in Section 132E(1) also extends to such transactions with directors of the holding company and persons connected with them.

The prohibition in Section 132E(1) is not an absolute prohibition. Consequently, such transactions may be entered into where the approval of the company in general meeting is obtained.<sup>41</sup> The Section is founded on the belief that the members of the company provide a more effective check on directors' self-dealing than the board of directors, who may themselves be distracted by conflict of interest.<sup>42</sup>

Some of the key phrases in Section 132E(1) are the phrases 'non-cash assets' and 'requisite value'. Both of the phrases are defined in the Section. Subsection (7) defines 'non-cash assets' as meaning any property or interest in property other than cash. Cash is specifically defined to include foreign currency. The definition of the phrase 'requisite value' is more complex. A non-cash asset is defined as being of the 'requisite value' if its value is 'not less than ten thousand ringgit but (subject to that) exceeds two hundred and fifty thousand ringgit or ten per centum of the company's asset value', at

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*(a) whereby a director of the company or its holding company, or a person connected with such a director, acquires or is to acquire one or more non-cash assets of the requisite value from the company; or*

*(b) whereby the company acquires or is to acquire one or more non-cash assets of the requisite value from such a director or a person so connected, unless the arrangement is first approved by a resolution of the company in general meeting and, if the director or connected person is a director of its holding company or a person connected with such a director, by a resolution in general meeting of the holding company."*

<sup>41</sup> Where the transaction or arrangement concerns a director of the holding company, or a person connected with a director of the holding company, the approval of the holding company in general meeting is required.

<sup>42</sup> Loh, *supra* note 2, 636; Davies, , P.L., Gower's Principles of Modern Company Law, (6th edition, 1997), 636.

the time of the arrangement or transaction.<sup>43</sup> The definition is rather ambiguous. The subsection does not make it clear whether the threshold value is RM10,000 or RM250,000. The words 'or ten per centum of the company's asset value' add further confusion as to which amount should be taken as the threshold.

Loh Siew Cheang opines that Section 132E(5) should be read as meaning that a non-cash asset is of the requisite value if it exceeds RM250,000, or 10% of the company's asset value, whichever is the lesser.<sup>44</sup> Loh further suggests that the 10% of the company's asset value should be subject to a minimum amount of RM10,000.<sup>45</sup> Accordingly, where 10% of the company's asset value exceeds RM250,000, the requisite value would be RM250,000. Where 10% of the asset value of the company is less than RM250,000, the requisite value is 10% of the company's asset value. If, however, 10% of the company's asset value is less than RM10,000, the requisite value would be RM10,000. However, as the legislation itself is ambiguous, it is submitted that legislative amendment is necessary to clarify the issue.

Another key phrase in Section 132E(1) is the phrase 'any arrangement or transaction'. The word 'arrangement', in particular, is reflective of the intention that Section 132E

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<sup>43</sup> Section 132E(5). The subsection reads as follows:-

*"For the purposes of subsection (1), a non-cash asset is of the requisite value if, at the time of the arrangement or transaction for the acquisition or disposal of the asset, its value is not less than ten thousand ringgit but (subject to that) exceeds two hundred and fifty thousand ringgit or ten per centum of the company's asset value, that is-*

*(a) except in a case falling within paragraph (b), the value of the company's net assets determined by reference to the accounts prepared and laid under Part VI in respect of the last financial year prior to the arrangement or transaction; or*

*(b) where no accounts have been so prepared and laid before that time, the amount of the company's called-up share capital."*

<sup>44</sup> Loh, *supra* note 1, 278. In *Joint Receivers and Managers of Niltan Carson Ltd v Hawthorne* [1988] BCLC 298, 320-1, Hodgson J held that the words 'whichever the lesser' or 'whichever the greater' should be read into the equivalent provision of the English companies legislation.

<sup>45</sup> Loh, *supra* note 1, 278.



should catch a wide range of transactions other than direct contracts between the company and a director.<sup>46</sup>

A wide meaning was accorded to the phrase 'any arrangement or transaction' in the case of *MUI Plaza Sdn Bhd v Hong Leong Bank Bhd*.<sup>47</sup> In *MUI Plaza*, Kalamathan Ratnam JC took the view that unity of purpose is required to constitute an 'arrangement or transaction' for the purposes of Section 132E. In this case, six tenancies were found to constitute an 'arrangement or transaction'. Although the tenancies were to commence on different dates, the landlord was the same party, the tenant was the same party and the premises were all within the same building. Moreover, the reason for entering into the tenancies appeared to be identical. As such, it was found that there was a clear unity of purpose, sufficient to constitute an 'arrangement or transaction' within the meaning of Section 132E.

A number of exceptions to the prohibition in Section 132E(1) are listed in Section 132F. These include transactions entered into between related companies<sup>48</sup> and transactions made in the ordinary course of business.<sup>49</sup>

#### 5.1.2.2 Consequences of contravention

Section 132E provides for various consequences of a contravention of subsection (1). Firstly, the arrangement or transaction is voidable at the instance of the company.<sup>50</sup> Nonetheless, if the company in general meeting should choose to ratify the arrangement or transaction, it may do so within a reasonable period.<sup>51</sup> This would serve to protect the company's interests, as the company may choose to ratify the arrangement or

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<sup>46</sup> Farrar, J.H. and Hannigan, B.M., *Farrar's Company Law*, (4th edition, 1998), 410.

<sup>47</sup> [1998] 6 MLJ 203.

<sup>48</sup> Section 132F(a).

<sup>49</sup> Section 132F(c).

<sup>50</sup> Section 132E(2).

<sup>51</sup> *Ibid*.

transaction if it considers the same to be beneficial. Alternatively, the company may avoid any arrangement or transaction which would be detrimental to its interests.

Secondly, subsection (3) stipulates that the director and the person connected with that director who entered into the arrangement or transaction with the company will be liable to account for any profits made from the arrangement or transaction. In addition, the director and the person connected with him will also be liable to indemnify the company for any loss or damage resulting from the arrangement or transaction. The subsection also provides that any director who authorised the arrangement shall also be liable to the company in the same manner.

In addition to the civil liability provided for in subsection (3), subsection (6) provides for criminal penalties for the contravention of Section 132E. The director, the person connected with him and the directors who authorised the arrangement or transaction will also be criminally liable for the contravention of Section 132E.

There appear to be no defences to liability under subsections (3) and (6). The equivalent provision in the companies legislation of the United Kingdom makes provision for two defences. The first defence applies to situations where an arrangement is entered into by the company and a person connected with a director. That director will not be liable if he can show that he took all reasonable steps to secure the company's compliance with Section 132E. The second defence applies to the person connected with the director and other directors who authorised the transaction. Both these categories of persons can avoid liability by showing that they did not know the relevant circumstances constituting the contravention, at the time the arrangement was entered into.



As noted in Section 5.1.1.1, under Section 133, directors similarly do not have any recourse to defences. As with Section 133, it is submitted that such defences would be in the interest of justice. The penalties for the contravention of Section 132E are fairly severe, particularly as criminal penalties are involved. Moreover, persons connected with directors may at times be unaware of arrangements made by directors. Similarly, other directors who do not benefit from the transaction and who merely authorise the transaction at a board meeting may be unaware of the director's interest in the transaction, if the defaulting director fails to disclose the true situation. It would seem rather harsh to impose criminal penalties on persons such as these. The defences provided for by the companies legislation of the United Kingdom would serve to protect parties who may be innocently unaware of the contravention from penalties which would appear to be undeserved.

Lastly, Section 132E also allows any member of the company to apply to the courts to restrain the company from entering into an arrangement or transaction in contravention of Section 132E(1).<sup>52</sup> The wording of subsection (4) appears to indicate that the application should be made to the courts before the company has entered into the arrangement or transaction. Hence, preventative action can be taken to prevent the assets of the company from being depleted by errant directors. However, in order to take action before the company has entered into the arrangement, the shareholders would need to be in a position to discover such a proposed arrangement at an early stage. Not all shareholders may have such access to information on the company's proposed dealings at a sufficiently early stage.

The recourse to the courts provided for by subsection (4) is particularly beneficial to minority shareholders. Although the general meeting is given the power to avoid or to

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<sup>52</sup> Section 132E(4).

affirm the arrangement or transaction, there may be situations in which minority shareholders may envisage that the general meeting would not protect their interests. This is particularly so, as the director involved in the transaction may vote as a shareholder despite his interest in the transaction.<sup>53</sup>

One of the criticisms of Section 132E is that it is ambiguous in various respects. As mentioned above, the definition of the phrase 'requisite value' requires clarification. In addition, the Section is also ambiguous as to whether it precludes the board of directors from executing a conditional agreement.<sup>54</sup> It is essential that the law laid down by Section 132E should be clear and certain, particularly as the penalties for the contravention of the Section include criminal penalties.<sup>55</sup> As with Section 133, legislative intervention for the purpose of addressing these issues would appear to be advantageous.

### **5.1.3 Transactions Involving Directors and Substantial Shareholders - Section 132G**

Section 132G<sup>56</sup> prohibits specified arrangements and transactions involving the interests of directors and substantial shareholders<sup>57</sup> of the company. There is a degree of overlap

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<sup>53</sup> *Guyler Magruder v Creative Solutions (M) Sdn Bhd* [1994] MLJU 107; *North-West Transportation Co Ltd v Beatty* (1877) 12 AC 589.

<sup>54</sup> Koh, *supra* note 3, xvi; Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 159.

<sup>55</sup> The penalties for contravention of Section 132E are imprisonment for five years or thirty thousand ringgit or both. The Finance Committee on Corporate Governance suggests that such penalties should be substantially increased; Finance Committee on Corporate Governance, *supra* note 53, 160-1.

<sup>56</sup> Section 132G(1) reads as follows:-

*"Notwithstanding the provisions of sections 132C and 132E, a company shall not enter into any arrangement or transaction to acquire the shares or assets of another company in which a shareholder or director of the acquiring company, or a person connected to such shareholder or director has a substantial shareholding as defined in section 69D whether or not for the benefit of such shareholder, director or connected person or for any other person unless the arrangement or transaction was entered into three years after such shareholder, director or connected person as the case may be, first held shares in that other company or after the assets were first acquired by the said company, as the case may be."*



between the transactions prohibited by Section 132E and those prohibited by Section 132G. Section 132E came into force on 1 February 1987. Whilst Section 132E helped in curbing self-dealing by directors, it was inadequate to restrain the abuse of the company's resources by directors and shareholders for personal gain.<sup>58</sup> As noted earlier, the check imposed on self-dealing by directors by Section 132E, namely the approval of the company in general meeting, is not foolproof. Directors, who are frequently also shareholders in the company, may use their voting power as shareholders to approve a wide range of transactions for their own benefit.<sup>59</sup>

Subsequently, Section 132G was enacted specifically for the protection of the minority shareholders.<sup>60</sup> Section 132G<sup>61</sup> came into force on 10 September 1992. The Section covers a wider range of arrangements and transactions. It also contains an absolute prohibition against specified transactions. Accordingly, such arrangements and transactions cannot be entered into even with the approval of the company in general meeting. Subsection (1) also specifically asserts the supremacy of Section 132G over Section 132E.

#### 5.1.3.1 *The prohibition*

The prohibition in Section 132G(1) essentially involves three entities. The first two entities involved are companies. Section 132G(1) prohibits a company from acquiring the shares or assets of another company. For the purposes of this chapter, the first company will be referred to as the 'acquiring company'. The second company will be

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<sup>57</sup> The phrase 'substantial shareholding' is defined in Section 69D of the Companies Act, 1965 (Act 125).

<sup>58</sup> Loh, *supra* note 2, 282-3.

<sup>59</sup> *Guyler Magruder v Creative Solutions (M) Sdn Bhd* [1994] MLJU 107; *North-West Transportation Co Ltd v Beatty* (1877) 12 AC 589. The limits as to what may be ratified or approved are discussed in greater detail in Chapter 7.

<sup>60</sup> Parliamentary Debates, Dewan Rakyat, Official Report, Eighth Parliament, Second Session, 20 July, 1992, 52.

referred to as the 'target company'. The third entity is the person who links the acquiring company to the target company.

In order to come within the ambit of Section 132G, there must be a substantial shareholder or director of the acquiring company who has a substantial shareholding in the target company. This also includes persons connected with a substantial shareholder or director of the acquiring company, who have a substantial shareholding in the target company.<sup>62</sup> Thus, the third entity is the substantial shareholder or director of the acquiring company, or a person connected with either of them, who has a substantial shareholding in the target company. For the purposes of this chapter, this person will be referred to as the 'related person'. Each of these three entities must be separate entities.<sup>63</sup> The case of *Actacorp Holdings v Anor*<sup>64</sup> confirms that Section 132G would not cover a situation where the related person is also the acquiring company.

Subsection (1) prohibits the acquiring company from entering into any arrangement or transaction to acquire the shares or assets of the target company, where the related person has a substantial shareholding in the target company. The rationale behind this prohibition is aptly described by Abdul Aziz Mohamad J:-

*"The evil to be avoided by Section 132G is not merely that the first entity acquires shares from the second entity. The evil is that the acquisition is at the time when there was such a said connection. The mischief arises from such a*

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<sup>61</sup> Section 132G was inserted into the Companies Act, 1965 (Act 125) by the Companies (Amendment) (No. 2) Act, 1992 (Act A836), s26. The Section was subsequently amended by the Companies (Amendment) Act, 1993 (Act 845).

<sup>62</sup> Subsection (4) specifies that a person connected with a shareholder or director shall have the same meaning as in Section 122A. However, a reference to a member of the shareholder or director's family is limited to the spouse and child of the shareholder or director.

<sup>63</sup> Loh, *supra* note 1, 285.

<sup>64</sup> (1993) 3 MSCLC 91,010.



*connection, something which puts a question mark on the integrity of the transaction and results in a possible conflict of interests situation.*<sup>65</sup>

The prohibition is an absolute prohibition. It is not subject to the approval of the general meeting. In addition, this prohibition operates regardless of whether the related person obtains any benefit from such an arrangement or transaction.

The consequences of contravening Section 132G are both civil and criminal in nature. Firstly, the arrangement or transaction made in contravention of the Section is void.<sup>66</sup> Subsection (2) also specifies that any consideration given for the shares or assets shall be recoverable by the company. Criminal penalties also follow the contravention of Section 132G. Subsection (5) stipulates that the acquiring company and every director of the acquiring company shall be guilty of an offence.

It is noted that by virtue of Section 132G(5), every director of the acquiring company is criminally liable upon contravention of the Section. This goes further than Sections 132E which imposes criminal liability only on the directors involved in the transactions and the directors who authorised the impugned transactions.<sup>67</sup> Section 132G also does not provide for any defences which a director can rely on to avoid liability under subsections (2) and (5). This is similar to the criminal liability of directors under Section 132E and Section 133, to which there is also no defence.

#### *5.1.3.2 Exceptions to the prohibition*

The prohibition in subsection (1) does not apply to two categories of arrangements and transactions. The first of these is set out in subsection (1). Where an arrangement or

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<sup>65</sup> *Id.* 91,021.

<sup>66</sup> Section 132G(2).

transaction is entered into 3 years after the related party first held shares in the target company, or 3 years after the assets were first acquired by the target company, the arrangement or transaction will not be caught by the prohibition.

The time period of 3 years is imposed for the purpose of deterring get-rich-quick schemes by directors and substantial shareholders.<sup>68</sup> The issue of the computation of the 3 year period in relation to the acquisition of shares was considered in *Actacorp Holdings v Anor*.<sup>69</sup> The court considered whether the 3 year period should be calculated from the time any shares were first held or from the time the substantial shares were first held. Abdul Aziz Mohamad J held by way of *obiter dicta* that the period of 3 years should commence from the date on which the substantial shares were first held.

The second category of exceptions is provided for in subsection (6). This subsection sets out a number of arrangements and transactions which are exempted from the prohibition of Section 132G(1). These include the subscription of new shares in a company for cash consideration.<sup>70</sup> Also included are arrangements or transactions for the acquisition of shares or assets entered into between a holding company and its wholly-owned subsidiary.<sup>71</sup> The acquisition of any asset, other than shares, in the ordinary course of business is also exempted.<sup>72</sup>

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<sup>67</sup> As with Section 132E, Section 133 imposes criminal liability only on directors who approved the impugned transactions.

<sup>68</sup> Loh, *supra* note 1, 283.

<sup>69</sup> (1993) 3 MSCLC 91,010.

<sup>70</sup> Section 132G(6)(a).

<sup>71</sup> Section 132G(6)(b).

<sup>72</sup> Section 132G(6)(c).



### 5.1.3.3 Critique

Section 132G is riddled with difficulties of interpretation.<sup>73</sup> Some of the difficulties frequently encountered are the scope to be attributed to the phrases 'the shares', 'the assets of another company' and 'first held the shares'. These complications are said to have had the effect of thwarting some corporate deals.<sup>74</sup> In addition, assistance cannot be drawn from the companies legislation and case law of Australia and the United Kingdom, as the equivalent of Section 132G is not found in their past or present legislation.

Although the cost of transactions has been raised by the statutory prohibition, it has not been demonstrated whether there are gains to be made by this provision.<sup>75</sup> The prohibition in Section 132G is essentially a prohibition against a certain form of arrangement and transactions. Although the intention behind the Section may have been to curb abuse of the company's assets and resources by those in control of companies, Section 132G makes no mention of the spirit of the law. Instead, it focuses on the form of the arrangement or transaction, rather than the substance of it.

As a consequence, various schemes have been devised by corporate players and their legal advisers in order to circumvent the prohibition in Section 132G. For instance, parties may attempt to circumvent Section 132G by entering into arrangements or transactions through a number of layers of nominees. Whilst these schemes may comply with the letter of the law, they may nonetheless contain the essence of what was intended to be prohibited, namely the abuse of the company's resources by directors and substantial shareholders.

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<sup>73</sup> Koh, *supra* note 2, xvi.

<sup>74</sup> *Ibid.*

<sup>75</sup> *Id.* xvii.

On the other hand, it has also been acknowledged that the absolute prohibition with respect to Section 132G transactions can sometimes have the effect of capturing genuine transactions.<sup>76</sup> Thus, it has been suggested that the necessity of the absolute prohibition contained in the Section should be reviewed.

The Australian companies legislation deals with financial benefits to related parties in Chapter 2E of the Corporations Law (Australia). In contrast to Section 132G, it is expressly stated in Chapter 2E that the economic and commercial substance and effect of what the entity has done is to prevail over its legal form. Thus, Chapter 2E focuses on the spirit of the law rather than on the form of the transaction.

It is suggested that this emphasis on prohibiting the substance of self-dealing rather than the form of the transaction may be more effective in deterring self-dealing by directors. This would also prevent directors from devising schemes to circumvent the prohibition in order to escape from liability. However, it is conceded that an emphasis on substance rather than form may leave some uncertainty as to when a transaction would fall within the prohibition.

## **5.2 Disclosure of Dealings by Directors**

In addition to prohibiting specified transactions, the Companies Act, 1965 (Act 125) also requires the disclosure of specified information by the company or its directors. These disclosure requirements exist for a number of reasons. One of the commonly cited reasons is the preservation of the integrity of companies and their directors.<sup>77</sup> Disclosure is seen to operate as a deterrent against directors' abuse of their positions. Another reason is to provide the public with adequate information about the affairs of

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<sup>76</sup> Finance Committee on Corporate Governance, *supra* note 53, 158.



the company in order to enable them to make informed decisions about investing in the company.<sup>78</sup>

As seen in Chapter 3, directors are required to disclose conflicts of interest under the common law and Section 131 of the Companies Act, 1965 (Act 125). In addition, the disclosure of specified interests is also required under Sections 134, 135, 137 and 169 of the Companies Act, 1965 (Act 125). Each of these provisions will be examined in greater detail below.

### 5.2.1 Sections 134 and 135

Sections 134 and 135 essentially require the disclosure of directors' interests in the company. As mentioned in Chapter 3, it is recognised that directors may hold shares in the company. Nevertheless, where a director holds shares in the company, there arises a possibility of a conflict between his fiduciary duty to the company and his interest as a shareholder. In *Raja Nong Chik v Public Prosecutor*,<sup>79</sup> Raja Azlan Shah J (as he then was) explained the implications of this potential conflict:-

*"The commercial morality expected of company directors is too well-known to be reiterated. Directors are expected to observe a high standard of conduct in connection with dealings with their own shares. They may buy or sell shares in the company in the ordinary course and the fact that they usually know more about their company than the other party to the transaction is no bar; but when they do buy or transfer shares, they have to notify the company in writing*

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<sup>77</sup> *Id.* 143.

<sup>78</sup> *Ibid.*

<sup>79</sup> [1971] 1 MLJ 190.

Section 134(1) provides that the nature and extent of the directors' interests are required to be shown in the register. This includes the number and description of the interests.<sup>87</sup>

The price or other consideration for the transaction as well as the date of the agreement for the transaction must also be shown in respect of interests acquired after the director accepted the office of a director.<sup>88</sup>

The register is to be open for inspection at the registered office of the company.<sup>89</sup> The Registrar of Companies as well as any person may request the company for a copy of its register.<sup>90</sup> The company is also required to produce its register at each annual general meeting.<sup>91</sup>

The consequences of contravention of this Section are severe. Where the company defaults, the company and every officer of the company who is in default are criminally liable.<sup>92</sup>

#### 5.2.1.2 Section 135

Section 135 is an essential supplement to Section 134. Section 134 requires the company to show the interests of the directors in a register. However, the company would not be able to show such interests unless the director makes the particulars known to the company. Hence, Section 135 imposes a duty on directors to notify the company in writing of such particulars as are necessary for the company to comply with

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<sup>85</sup> *Ibid.*

<sup>86</sup> *Ibid.*

<sup>87</sup> Section 134(5).

<sup>88</sup> *Ibid.*

<sup>89</sup> Section 134(8).

<sup>90</sup> Section 134(9) and (10). It is to be noted that a copy of the register will be furnished to persons other than the Registrar subject to the payment of a prescribed fee.

<sup>91</sup> Section 134(11).

<sup>92</sup> Section 134(14). The penalty for failure to comply with Section 134 is imprisonment for three years or fifteen thousand ringgit. The penalty for the breach of the equivalent UK provisions is a fine, rather than imprisonment.



has been suggested that disclosure should also be made of interests held by directors' spouses and children.<sup>102</sup>

## 5.2.2 Section 137

### 5.2.2.1 The rule in Section 137

Section 137(1) makes unlawful various payments made to directors.<sup>103</sup> Firstly, it makes any payment to a director for loss of office or retirement unlawful. Secondly, it also makes unlawful any payment to a director made in connection with the transfer of the undertaking or property of the company. The rule is conditional. It allows such payments to be made on the condition that the particulars concerning the proposed payment have been disclosed to the members of the company. In particular, the amount of the payment must be disclosed. Further, the proposed payment must have been approved by the company in general meeting before such payment can be made.

The definition of 'director' for the purposes of this Section is wider than the definition of 'director' in Section 4 of the Companies Act, 1965 (Act 125). Section 137(7) specifies that the term 'director' for the purposes of Section 137 includes any person who has at any time been a director of the company or of a related company. It is also to be noted that the duty of disclosure under Section 137 is in addition to the equitable duty of disclosure.<sup>104</sup>

The first category of unlawful payments under Section 137(1) is payments made to a director by way of compensation for the loss of office as an officer of the company or a

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<sup>102</sup> Finance Committee on Corporate Governance, *supra* note 53, 157. It is noted that Section 156 of the Companies Act (Cap 50) (Singapore) and Section 328 of the Companies Act, 1985 (UK) provide for disclosure of interests held by spouses and children, in addition to disclosure of interests held by directors.

<sup>103</sup> Similar provisions are found in Sections 312 and 313 of the Companies Act, 1985 (UK).

<sup>104</sup> Section 137(6).

subsidiary. Payments made to a director as consideration for, or in connection with, his retirement from such office are also included in this category of payments.

The making of such payments by the board of directors to one of the directors is potentially affected by a conflict of interest. Directors could easily be tempted to compromise the interest of the company in the hope that they would themselves receive such benefits in the future. In view of this potential conflict of interest, the rule against making such payments, unless the approval of the members is obtained, appears to be a prudent safeguard of the company's interest.

Not every payment made to a director upon cessation of his employment with the company would fall within the Section.<sup>105</sup> Severance benefits may be given to a director as part of his remuneration package. Such benefits are paid as part of the director's remuneration rather than with the object of compensating the director for loss of office or as consideration for his retirement. Accordingly, the benefits would not come within Section 137(1).<sup>106</sup>

The second category of unlawful payments under Section 137(1) is the payment to any director of the company made in connection with the transfer of the whole or any part of the undertaking or property of the company. In negotiations for the sale of the company's undertaking or property, it is essential that directors should act solely in the interest of the company. If directors were permitted to receive payment from the purchaser in relation to such a sale, directors may be tempted to act in their own interest rather than in the interest of the company.

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<sup>105</sup> *Grinsted v Britannia Brands (Holdings) Pte Ltd* [1996] 2 SLR 97; *Lincoln Mills (Australia) Ltd v Gough* [1964] VR 193.

<sup>106</sup> *Ibid.*



It is noted that the rule appears to extend to payments made by any person or entity. What is essential is that the payments should be made to a director of the company in connection with the transfer of the company's undertaking or property. As with the first category, the rule is conditional. Thus, if details of the proposed payment are disclosed to shareholders of the company and approved, such payments can be made to the director. It is assumed that such disclosure to shareholders would deter directors from preferring their own interest over the interest of the company.

If any payment is made to a director contrary to Section 137(1), the payment is deemed to be received by that director in trust for the company.

#### *5.2.2.2 Exceptions to the rule*

Various payments are excluded from the rule in subsection (1). These exclusions are set out in subsection (5). Payments which are permitted include any bona fide payment by way of damages for breach of contract.<sup>107</sup> A company may also make payments to directors under an agreement, provided that particulars of the same have been disclosed to the members and approved by special resolution.<sup>108</sup> Bona fide payments by way of pension or lump sum payment in respect of past services are also permitted.<sup>109</sup> However, the value of the pension or payment must not exceed the total emoluments of the director within the 3 years immediately preceding his retirement.<sup>110</sup> In addition, payment may also be made pursuant to an agreement made prior to the director becoming a director of the company. This payment should form part of the consideration for the director agreeing to serve as a director.<sup>111</sup>

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<sup>107</sup> Section 137(5)(c). A similar exception is found in Section 316(3) of the Companies Act, 1985 (UK).

<sup>108</sup> Section 137(5)(b).

<sup>109</sup> A similar exception is found in Section 316(3) of the Companies Act, 1985 (UK).

<sup>110</sup> Section 137(5)(d).

<sup>111</sup> Section 137(5)(e).

First of all, the directors' report should contain particulars of the directors interests in accordance with the register kept pursuant to Section 134.<sup>115</sup> The report should reveal the total number of shares and debentures of the company, or a related company, which have been bought or sold by the director during that year.<sup>116</sup>

Secondly, where the company is a party to any arrangement with the object of enabling a director to acquire any benefit to shares or debentures of the company, or any other body corporate, disclosure must be made of the arrangement.<sup>117</sup> This includes situations where the benefit to the shares or debentures may be held by nominees of directors.

The third category of interests would be the benefits received by directors by reason of a contract with the company or a related company.<sup>118</sup> This also includes benefits which directors are entitled to receive by reason of such a contract. These contracts need not be made directly with the directors. Contracts made with a firm of which the director is a member, or a company in which he has substantial financial interests, must also be made known. The directors are required to state the general nature of the benefit conferred by the contract in their report. Nonetheless, benefits such as emoluments or salary received by the directors which are shown in the accounts need not be disclosed.

Disclosure must also be made in the profit and loss accounts of various interests. In particular, the amounts of fees and other emoluments paid to directors by the company or its subsidiaries as remuneration must be stated in the profit and loss accounts.<sup>119</sup>

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<sup>115</sup> Section 169(6)(g). A similar provision is found in Section 234 of the Companies Act, 1985 (UK) which is read together with Schedule 7 of the Companies Act, 1985 (UK).

<sup>116</sup> Section 169(6)(g)(iii).

<sup>117</sup> Section 169(6)(f).

<sup>118</sup> Section 169(8).

<sup>119</sup> Items (o), Ninth Schedule, Companies Act, 1965 (Act 125).



Any compensation paid to directors for loss of office and any pension should also be included.<sup>120</sup>

Where benefits are given to directors otherwise than in cash by the company or a subsidiary, the estimated money value of these benefits should also be stated in the profit and loss accounts.

Lastly, amounts paid to a third party in respect of services provided by a director to the company or a subsidiary must also be disclosed.<sup>121</sup> This requirements also extends to services provided by a past director of the company.

#### 5.2.4 *The Effectiveness of Disclosure*

As seen above, the Companies Act, 1965 (Act 125) requires disclosure of various interests of directors which may potentially give rise to conflicts of interests. These disclosure requirements are based on the notion that transparency promotes fidelity. Disclosure is seen to operate as a deterrent against directors breaching their fiduciary duties to the company.

Disclosure by itself is not sufficient to prevent misconduct by directors. What is equally crucial is the information which is required to be disclosed. The information that directors should disclose should be information that would expose any infidelity of directors towards the company. Disclosure of information which is irrelevant for these purposes is as good as non-disclosure. On the other hand, requiring disclosure of excessive information may incur substantial costs. The optimum position would be to

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<sup>120</sup> *Ibid.*

<sup>121</sup> Item (p), Ninth Schedule, Companies Act, 1965 (Act 125). Similar provisions are found in Section 232 and Schedule 6 of the Companies Act, 1985 (UK).

require disclosure of relevant information, that is, disclosure of information that would be likely to curb abuses by directors.

It remains to be seen whether the disclosure requirements of the Companies Act, 1965 (Act 125) fall within this optimum position. It is noted, however, that the disclosure provisions of the Kuala Lumpur Stock Exchange listing requirements have recently been amended so as to enhance disclosure in respect of related party transactions.<sup>122</sup> Perhaps it would be prudent to similarly examine the effectiveness of the disclosure requirements under the Companies Act, 1965 (Act 125) in order to ensure that they will produce the optimum result. This is so, particularly in view of the increasing separation between the ownership and control of the company. In a substantial number of companies, shareholders frequently have little knowledge of the day to day dealings of the company.<sup>123</sup> Hence, there is a need to require disclosure of the company's dealings, so as to enable shareholders to exercise some measure of informed control of the company.

It is also noted that the penalties for non-compliance of these disclosure requirements are essentially criminal.<sup>124</sup> Accordingly, there is no provision for civil consequences, even where there is intentional or reckless failure to disclose. Similarly, there are no civil consequences for misleading or deceptive statements. It has been suggested that civil consequences should follow the failure to comply with disclosure requirements in such circumstances.<sup>125</sup> In particular, it is submitted that shareholders should be allowed

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<sup>122</sup> Kuala Lumpur Stock Exchange and Price Waterhouse Coopers, Corporate Governance: 1998 Survey of Institutional Groups, (1998), 35.

<sup>123</sup> Brudney, V., Clark, R.C., 'A New Look at Corporate Opportunities', (1981) 94 Harvard Law Review 997, 1003

<sup>124</sup> There are only criminal penalties for breaches of Sections 134, 135 and 169. Section 137, however, provides that any amounts paid in contravention of Section 137 are deemed to be held by the director on trust. Hence, limited civil remedies are available under Section 137.

<sup>125</sup> Finance Committee on Corporate Governance, *supra* note 53, 147. The Australian Senate Standing Committee on Legal and Constitutional Affairs has also recommended that civil penalties be provided for in the companies legislation for breaches of directors' duties. The



to recover damages against directors where the directors' misleading or deceptive statements have resulted in loss.<sup>126</sup> Such civil liability may also result in stricter policing by shareholders of the directors' compliance with the disclosure requirements. It would also operate as an incentive to directors to ensure that the disclosure requirements are complied with.

### 5.3 The Companies Legislation of Australia and the United Kingdom

A perusal of the companies legislation of Australia and the United Kingdom reveals that the provisions of the Companies Act, 1965 (Act 125) have a narrower ambit than the provisions regulating self-dealing by directors in Australia and the United Kingdom. In particular, the Companies Act, 1965 (Act 125) fails to cover a number of transactions involving directors' self-dealing.

The Companies Act, 1985 (UK), for instance, restricts transactions such as quasi-loans<sup>127</sup> and credit transactions,<sup>128</sup> in addition to loans. It also deals with arrangements which circumvent the prohibition on the making of loans to directors.<sup>129</sup> For example, a company must not arrange for the assignment to it, or the assumption by it, of any rights, obligations or liabilities under a transaction which would have been prohibited if it had been entered into by the company.<sup>130</sup> Companies are also prohibited from taking part in any arrangement in which another person enters into a transaction which would

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Committee recommended that in appropriate circumstances, people suffering loss as a result of the breaches should be allowed to bring claims for damages; Australian Senate Standing Committee on Legal and Constitutional Affairs, The Cooney Report, (November 1989); Sheikh, S. and Chatterjee, S.K., 'Perspectives on Corporate Governance', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 52.

<sup>126</sup> Finance Committee on Corporate Governance, *supra* note 53, 147.

<sup>127</sup> Section 330(3) of the Companies Act, 1985 (UK).

<sup>128</sup> Section 330(4) of the Companies Act, 1985 (UK).

<sup>129</sup> Sections 330(6) and (7) of the Companies Act, 1985 (UK).

<sup>130</sup> Section 330(6) of the Companies Act, 1985 (UK).

have been a prohibited loan, quasi-loan, credit transaction, guarantee, security or assignment, if it had been entered into by the company.<sup>131</sup>

Australia has in Chapter 2E of the Corporations Law (Australia) also introduced provisions prohibiting the giving of financial benefits to related parties of public companies. Section 243H(1)<sup>132</sup> prohibits the giving of financial benefits to related parties, except as permitted by the legislation.<sup>133</sup> As such, it catches not merely a few specified transactions, but rather all such transactions which are not expressly excluded. This is clearly a much wider provision than the existing provisions of the Companies Act, 1965 (Act 125).

Apart from including directors and persons connected with directors, Chapter 2E defines related parties as including entities who were related parties at any time within the previous 6 months.<sup>134</sup> Entities likely to become a related party at a future time are also related parties.<sup>135</sup> In addition, the definition of related parties also includes entities acting in concert with the recipient of the benefit in respect of the giving of the financial benefit.<sup>136</sup> Thus, the definition of related parties under Chapter 2E of the Corporations Law is much wider than the equivalent definition under Section 122A of the Companies Act, 1965 (Act 125). This wider definition of related parties is likely to

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<sup>131</sup> Section 330(7) of the Companies Act, 1985 (UK).

<sup>132</sup> Section 243H(1) of the Corporations Law (Australia) reads as follows:-

*"A public company must not give a financial benefit to a related party except as permitted by Division 4 or 5."*

<sup>133</sup> It is noted that Part 9.4B of the Corporations Law (Australia) provides for specified civil consequences of contravention of Section 243H(1) of the Corporations Law (Australia). These include pecuniary penalties to be paid to the Commonwealth, compensation to the company for any loss or damage suffered; Section 1317HA Corporations Law (Australia). Section 1317HD provides for an account to the company for any profit gained by the person in breach. It is to be noted that these consequences are in addition to and not in derogation of any other rule of law relating to directors; Section 1317HE Corporations Law (Australia).

<sup>134</sup> Section 243F(2) of the Corporations Law (Australia).

<sup>135</sup> Section 243F(3) of the Corporations Law (Australia).

<sup>136</sup> Section 243F(5)(b) of the Corporations Law (Australia).



be more effective in dealing with transactions made by directors through layers of nominees.

Section 243G(1) of Chapter 2E of the Corporations Law (Australia) also states that the prohibition against the giving of financial benefits is intended to operate broadly. The giving of financial benefits is expressly stated to include financial benefits given indirectly. Examples of financial benefits include the forgiving of a debt, the leasing of assets, services given or acquired, the issuance of securities and the granting of options.<sup>137</sup> The Chapter comprehensively covers various benefits and the ways in which benefits may be conferred. Further, the economic and commercial substance and effect of what the entity has done is to prevail over its legal form.<sup>138</sup> Such a provision deals with the spirit of the law. Consequently, it leaves little room for manipulation of transactions in order to circumvent the prohibitions on self-dealing. Nevertheless, such a provision arguably provides less clear parameters within which directors can operate, as compared with the existing Malaysian statutory provisions. It is also arguable that such a provision may at times catch transactions which were not calculated to grant a benefit to a director or a party related to him.

It is submitted that the provisions of Chapter 2E of the Corporations Law (Australia) are more effective in curbing self-dealing by directors than the existing provisions of the Companies Act, 1965 (Act 125). In particular, Chapter 2E deals not only with self-dealings that are obviously in breach of fiduciary duties, but also with the more subtle schemes which enable directors to procure benefits for themselves.

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<sup>137</sup> Section 243G(4). In addition, Section 243G(3) expressly mentions that benefits that do not involve the payment of money can still be financial benefits for the purposes of Chapter 2E, as long as the benefit confers some financial advantage.

<sup>138</sup> Section 243G(2).

The comparison with provisions of the companies legislation of Australia and the United Kingdom reveals that the Companies Act, 1965 (Act 125) fails to deal with many forms of indirect self-dealing. A shrewd director may not be deterred by the prohibitions and restrictions contained in the Companies Act, 1965 (Act 125). He may, instead, resort to various schemes to circumvent these prohibitions and restrictions. As a consequence, directors may indirectly be encouraged to disguise breaches of fiduciary duty such that they are more difficult to detect.

As mentioned at the beginning of this chapter, the purpose of the prohibitions and disclosure requirements of the Companies Act, 1965 (Act 125) is the reinforcement of fiduciary principles. These objectives can be said to have been achieved if the provisions of the Companies Act, 1965 (Act 125) have contributed to the deterrence of misconduct on the part of directors. However, if errant directors are merely encouraged to disguise their self-dealing and make such self-dealing harder to detect, the objective of the provisions is undeniably defeated.

This is a result which is opposed to the purpose of the statutory provisions relating to directors' self-dealing. It calls for a re-examination of the provisions of the Companies Act, 1965 (Act 125) with a view to addressing the weaknesses of the provisions. The need for re-examination is especially pertinent with regard to the provisions prohibiting or restricting various transactions and arrangements involving self-dealing. Such need for legislative reform to address the gaps in the existing statutory provisions has been recognised by the Finance Committee on Corporate Governance.<sup>139</sup>

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<sup>139</sup> Finance Committee on Corporate Governance, *supra* note 53, 121-2.



## 5.4 Proposals for Legislative Reform

In its Report on Corporate Governance issued in February 1999, the Finance Committee on Corporate Governance noted various instances of corporate abuse, which were observed particularly during the recent economic crisis. They included related party transactions, asset shifting as well as blatant and abusive conflict of interest transactions without proper disclosure by directors.<sup>140</sup> The Committee attributed these corporate abuses partly to ineffective corporate governance structures.<sup>141</sup>

Similar observations have been made by the Australian Companies and Securities Advisory Committee in respect of the Australian corporate scene. In July 1991, the Companies and Securities Advisory Committee acknowledged in its report that the lack of specific provisions in the Corporations Law (Australia) had allowed corporate controllers to abuse their positions of trust.<sup>142</sup> This, too, was done by various means of shifting of assets away from companies into their own hands. It was also noted that at that time, these arrangements and transactions were not specifically regulated by the Corporations Law (Australia).<sup>143</sup>

As a result, the Australians repealed Section 234 of the Corporations Law (Australia),<sup>144</sup> which is *pari materia* to Sections 133 and 133A of the Companies Act, 1965 (Act 125), in 1994. In addition, Chapter 2E of the Corporations Law (Australia) was enacted. The basic principle of Chapter 2E is that 'uncommercial' transactions with related parties should be referred to disinterested shareholders before the transactions

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<sup>140</sup> *Id.* 42-3.

<sup>141</sup> *Ibid.*

<sup>142</sup> Companies and Securities Advisory Committee, Report on the Reform of the Law Governing Corporate Financial Transactions, July 1991.

<sup>143</sup> *Ibid.*

<sup>144</sup> It is noted that the Corporations Law (Australia) at the relevant time did not contain the equivalent of Sections 132E and 132G of the Companies Act, 1965 (Act 125).

take place.<sup>145</sup> As discussed above, Chapter 2E catches a much wider range of transactions, including those from which directors derive benefit through indirect means. Such provisions appear to be more effective in reinforcing fiduciary principles than the present provisions of the Companies Act, 1965 (Act 125).

Notably, however, the Australian reforms apply only to public companies. Hence, a higher standard is required of public companies than private companies in Australian company law. This leads to the question as to whether there are valid reasons for imposing higher standards on public companies with regard to self-dealing.

#### *5.4.1 Public Companies v Private Companies*

An examination of whether there is a greater need for stricter regulation of self-dealings in public companies is facilitated by a brief comparison between public and private companies. Public companies generally have larger numbers of shareholders than private companies.<sup>146</sup> A significant number of Malaysian public companies are companies listed on the stock exchange. Public listed companies frequently have fairly large numbers of shareholders, many of whom regard their shareholding as investments,<sup>147</sup> leaving the management of the company to others. Hence, in these situations, there would be a separation between the ownership and the control of the

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<sup>145</sup> The Explanatory Memorandum for the Corporate Law Reform Bill 1992 (Australia), para 213.

<sup>146</sup> A private company is restricted to a maximum of fifty shareholders by Section 15(1) of the Companies Act, 1965 (Act 125).

<sup>147</sup> Griffiths, A., 'Shareholding and the Governance of Public Companies', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 59; Miles, L., Proctor, G., 'Unresponsive shareholders in public companies: dial "M" for motivate?', (2000) 21 The Company Lawyer 142, 142-3.



company.<sup>148</sup> The control of the company would frequently be exercised by a few substantial shareholders.<sup>149</sup>

In contrast, the number of shareholders of private companies is restricted.<sup>150</sup> In addition, many shareholders would often be involved in managing the company,<sup>151</sup> or would have the means of monitoring the dealings of the company.<sup>152</sup> Hence, in private companies ownership and control are far more closely linked than in public companies.<sup>153</sup> Nonetheless, despite these differences between private and public companies, company law imposes the same requirements on both types of companies with regard to self-dealing.

It is submitted that there is a greater need for regulation of self-dealing in public companies, in view of the greater separation between ownership and control in public companies. In particular, shareholders in public companies are less likely to be involved in the management of the company. Consequently, they may not be aware of transactions involving self-dealing. Even where they might suspect that a transaction involves self-dealing, they may not have access to sufficient information to verify their

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<sup>148</sup> Pennington notes that it is rare for a director of a public company to hold a majority of its issued share capital; Pennington, R.R., *Company Law*, (7th edition, 1995), 1024.

<sup>149</sup> Farrar, *supra* note 45, 9; Finance Committee on Corporate Governance, *supra* note 53, 62.

<sup>150</sup> Section 15(1) of the Companies Act, 1965 (Act 125).

<sup>151</sup> Griffiths, *supra* note 146, 58-59. Pennington, *supra* note 147, 1025; Miles, *supra* note 146, 142.

<sup>152</sup> According to Professors Brudney and Clark, investors in private companies are fairly small in number and tend to know one another. They are likely to be active participants rather than mere passive contributors of funds, and are likely to be more familiar with the affairs of the company and have better access to information. They can consent in a more meaningful way to diversions of corporate assets by fellow participants, and accordingly have less need of restrictions on such diversions; Brudney, *supra* note 122, 1022; Miles, *supra* note 146, 142.

<sup>153</sup> Miles, *supra* note 146, 142.

suspensions. As such, they would be unable to ascertain whether there has been self-dealing and to seek redress for their grievance.<sup>154</sup>

The increase in separation between ownership and control coupled with the development of increasing elaborate structures among modern companies also arguably increases the potential for self-dealing. As mentioned in Chapter 2, these conglomerates, which are commonly found among public companies, often engage in transactions within the conglomerate. These transactions at times involve terms more favourable to a party than ordinary 'arm's-length' commercial transactions for the reason that the parties are frequently related companies. The complex relations between companies in a conglomerate may often create difficulty for shareholders attempting to monitor the company's transactions. Transactions involving self-dealing by directors may slip by unnoticed among these transactions.

These issues would seem to indicate that there is a greater potential for self-dealing to remain undetected in public companies. Accordingly, there would be a greater necessity for regulation of self-dealing in relation to public companies. As discussed in Chapter 2, the developments in the modern company call for the adaptation of the directors' duties to the changing needs of the company. As seen above, the public company bears a greater similarity to the modern company discussed in Chapter 2. In contrast, the private company would appear to be more similar to the traditional company.

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<sup>154</sup> Professors Brudney and Clark opine that the ability of shareholders of public companies to monitor the behaviour of the officers of the company is nearly as ineffective as the ability of a beneficiary to monitor the trustee. Consequently, the rules needed to protect dispersed shareholders of public companies against the tendency of officers to divert corporate assets should be as rigorous as those that protect beneficiaries against trustees' efforts to make personal use of trust assets: Brudney, *supra* note 122, 1023.



Nonetheless, the differences between public and private companies are further complicated by the fact that public companies frequently have subsidiaries which are private companies. And it is through these private company subsidiaries that public companies often conduct a substantial part of their business. As such, although these private companies may have few shareholders, they operate as an extension of the public companies. Thus, shareholders of the public companies which have private company subsidiaries would still encounter the same problems of separation of ownership and control highlighted above. It is, therefore, submitted that the same need for regulation of self-dealing arises with these subsidiaries of public companies.<sup>155</sup>

From the above, it is evident that there are significant differences between public and private companies. Nonetheless, the provisions of the Companies Act, 1965 (Act 125) relating to self-dealing by directors apply uniformly to both public and private companies despite pertinent differences between the two types of companies. It would appear that the provisions of the Companies Act, 1965 (Act 125) should be re-examined in view of the significant practical differences between public and private companies.

## 5.5 Conclusion

It is submitted that the inadequacies of the existing statutory provisions governing self-dealing by directors warrant legislative reform in order to address these issues. As seen in earlier chapters, the legislative provisions do not provide clarification to the ambiguities of the equitable no-conflict and no-profit rules. Other inadequacies of the statutory provisions have been highlighted earlier in this chapter. One of the most

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<sup>155</sup> It is noted that Section 243H(2) of the Corporations Law (Australia) prohibits the giving of a financial benefit by a child entity of a public company to a related party. The Section states the following:-

*"A child entity of a public company must not give a financial benefit to a related party of the public company except as permitted by Division 4 or 5."*

Hence, it recognises that public companies also act through their subsidiaries.

pertinent of these is that the statutory provisions prohibiting specified transactions and arrangements involving self-dealing fail to deal with various schemes, allowing directors to engage in self-dealing indirectly.

In addition, the problems raised by the separation of ownership and control, particularly in relation to public companies and their subsidiaries, heighten the need for legislative reform. The increase in separation between ownership and control in public companies and their subsidiaries calls for greater disclosure of dealings by those in control of the company. It also warrants stricter regulation of self-dealing than in traditional private companies, as there is a greater potential for self-dealing.<sup>156</sup>

Nonetheless, in considering a reform of legislative provisions relating to self-dealing, a number of factors should be borne in mind. Firstly, the trend in Australia and the United Kingdom<sup>157</sup> towards stricter regulation of self-dealing has reflected a shift in power from directors to shareholders. By shifting the responsibility for such transactions to shareholders, shareholders are indirectly cajoled into behaving more like

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<sup>156</sup> It is submitted that the need for greater regulation of public companies and their subsidiaries in relation to self-dealing has been recognised by the Securities Commission. Chapter 20 of the Policies and Guidelines on Issue/Offer of Securities issued by the Securities Commission imposes additional requirements on listed public companies and their subsidiaries in relation to related-party transactions. These include disclosure of details of the transaction including particulars of the nature and extent of the interest of the related party in the transaction, an independent valuation of the assets involved and an opinion by an independent corporate adviser as to whether the transaction is fair and reasonable so far as the shareholders of the company are concerned. The sanctions which may be imposed on directors for failure to comply with the provisions are caution letters, reprimands, prohibition of dealing in the company's securities held by the relevant director, recommendation that the director be removed from office, and prosecution under the provisions of the Securities Commission Act 1993 (Act 498) or the Securities Industry Act 1983 (Act 280). It is noted that these sanctions do not include restitutionary remedies which may be pursued by the company against errant directors. In contrast, the remedies provided for by existing statutory provisions relating to self-dealing include indemnities to the company for any loss (Section 132E(3) and Section 133(3) of the Companies Act, 1965 (Act 125)), for the transaction to be avoided (Section 132E(2) and Section 132G(1) of the Companies Act, 1965 (Act 125)) and for recovery of the amount of the loan, guarantee or security made in contravention of the provisions (Section 133(5) and Section 133A(3) of the Companies Act, 1965 (Act 125)). Hence, it is submitted that legislative reform along the lines of Chapter 20, but providing for wider remedies such as those available under the Companies Act, 1965 (Act 125), should be considered.

<sup>157</sup> Griffiths, *supra* note 146, 69-71.



the owners of private property.<sup>158</sup> This appears to deal with the issue of separation between the ownership and control of companies. This also arguably has the effect of reducing the potential for self-dealing by directors who would otherwise have control over the companies' assets relatively free from the scrutiny of shareholders.

However, shifting the power to authorise these transactions from directors to shareholders is not a panacea. In public companies, shareholders are unlikely to act as a cohesive body.<sup>159</sup> As a consequence, shareholders who own a controlling stake in the company may be able to determine the outcome of the general meeting. Shareholders owning small stakes in the company may be unable to exercise significant influence through their votes in such circumstances. As the directors are often likely to be the nominees of controlling shareholders, the shift of power to shareholders may not prove to be a deterrence against self-dealing.

In addition, the company is an entity with an infinite life-span. Its shareholders are likely to be motivated by shorter-term considerations, and may not attach significant value to profits arising in the distant future.<sup>160</sup> Hence, although shifting the power to authorise transactions involving potential self-dealing may lessen the potential for directors to appropriate company's property for themselves, it raises other problems.

Secondly, it should also be borne in mind that greater restrictions on corporate transactions may have the effect of stifling corporate entrepreneurship and activity.<sup>161</sup> It is essential that a healthy balance should be maintained between regulations aimed at

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<sup>158</sup> *Id.* 71.

<sup>159</sup> *Ibid.*

<sup>160</sup> *Id.* 73. For this reason, Griffiths argues that more is required than merely regulating the existing system of governance, or shifting the balance of power within companies. He argues that alternative governance structures should be considered, and that the company should not be treated as a permanent and unchangeable fixture, but should be reviewed as an integral part of the corporate governance problem.

<sup>161</sup> Barrock, L., 'The unfortunate minorities', *The Edge*, 18 September 2000.

detering abuse of position by directors on the one hand, and the encouragement of corporate activity on the other hand.

Thirdly, in considering the regulations of other jurisdictions with a view to amending our local regulations, it should be borne in mind that the local culture and corporate conditions may vary from the conditions in other jurisdictions. Accordingly, what is appropriate for other jurisdictions may not necessarily be appropriate to our local conditions.

In conclusion, it is evident that the current statutory provisions governing self-dealing are in need of reform. Nevertheless, it is equally important that any statutory amendments be carefully considered in the light of the considerations mentioned above. In particular, care must be taken to avoid over-regulation and the stifling of corporate entrepreneurship and activity. And given that our local corporate conditions may differ from that of other jurisdictions, the more recent developments in the statutory provisions of other jurisdictions should not be adopted without first carefully considering the applicability of such restrictions to the Malaysian corporate scene.



Controversies involving the issue of directors' self-dealing were the focal point of much discussion during the economic downturn of 1997. Self-dealing by directors continues to be an issue frequently debated. It is now recognised that some measures must be taken to address the problem of self-dealing in order to promote investor confidence in Malaysian companies.<sup>1</sup> Generally these measures include greater corporate governance and more disclosure and transparency in corporate dealings.<sup>2</sup> In earlier chapters, a number of specific issues concerning the law relating to self-dealing have been canvassed.

Various corporate transactions have attracted criticism on the grounds that they have involved self-dealing by directors. A few examples of these transactions will be examined below in the light of the law governing self-dealing by directors. It is in examining these transactions that some of the shortcomings of the fiduciary duties and legislation discussed in earlier chapters are brought to light. Similarly, the examination of these situations illustrates and emphasises the need for reform of the existing rules on self-dealing.

### **6.1 A Berhad's Acquisition of the Shares of B Berhad**

The first example to be examined involved the acquisition by A Berhad of a substantial number of the shares of B Berhad. Among the controversial aspects of the transaction were the fact that B Berhad was, at the time of the acquisition, a major shareholder of A

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<sup>1</sup> Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 43; Wong, S.N., 'Ensuring A Sustainable Economic Recovery: The Role of the Capital Market', Forum Ekonomi Bersama Tenaga Pengajar Universiti Malaya, Kuala Lumpur 26 July 2000.

<sup>2</sup> *Ibid.*

Berhad. Accordingly, the transaction was perceived as a bailout of a major shareholder at the expense of minority shareholders.

Significantly, one of the directors of B Berhad was also a director of A Berhad. This director also had a substantial shareholding in B Berhad. Hence, the issue of self-dealing arose. Notably, the acquisition was made on the open market. As such, it appeared unlikely that such a transaction would come within the ambit of Sections 132E and 132G of the Companies Act, 1965 (Act 125). Section 132E regulates transactions where the company purchases property from a director or a person connected with a director. In the case of Section 132G, the provision also extends to purchases from a company in which a director or substantial shareholder or persons connected with them have substantial shareholdings. A purchase on the open market would be unlikely to be caught by these provisions, without evidence of purchase from such persons.

The fiduciary no-profit rule and no-conflict rule are, however, wider than the legislative provisions. As regards the no-profit rule, it would need to be shown that the director concerned obtained a profit by virtue of his position as a director. Arguably, the director concerned may be seen as having obtained an indirect profit or benefit through the acquisition, as it would have had a positive influence on the market price of the shares in B Berhad. Nevertheless, the profit accrued to the director was indirect, and it is questionable how direct the profit should be for the purposes of this rule.

As discussed in Chapter 4, there remains some uncertainty as to whether the stricter construction of the no-profit rule should be applied or the more liberal approaches. As regards the issue of how direct the profit should be in order to attract the application of the rule, again there does not appear to be any hard and fast rule. Case law on the no-



profit rule has generally concerned profit obtained directly, such as purchases made by the company from a director which resulted in him obtaining a profit. However, the limits as to how direct the profit should be does not appear to have been clearly defined. This appears to highlight the ambiguity or uncertainty of the fiduciary principles, which are generally wider in ambit than the legislative provisions, but less precise.

As for the no-conflict rule, fiduciary principles preclude directors from acting in a manner which will bring their personal interest into conflict with the company's interest. Case law indicates that the rule will apply to a possible conflict that is real and sensible, rather than theoretical and abstract.<sup>3</sup> As with the no-profit rule, there arises the issue of how direct a personal interest the director should have in the matter before he can be said to have a conflict of interest with the company.

## 6.2 C Berhad's Disposal of D Sdn Bhd

Another example of a controversial corporate transaction involved the disposal by C Berhad of D Sdn Bhd. The entire share capital of D Sdn Bhd, consisting of a few million shares of RM1 each, was sold by C Berhad for the sum of RM1. This value was said to have been arrived at after considering D Sdn Bhd's financial position at the time.

Nonetheless, observers noted that D Sdn Bhd had several lucrative businesses. The sale was made to a company connected to a former director of C Berhad. Notably, this director had resigned from C Berhad shortly before the transaction took place. Accordingly, the transaction was perceived as a 'golden handshake' to the former director.

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<sup>3</sup> *Boardman v Phipps* [1967] 2 AC 46; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1.

A perusal of the legislative provisions on self-dealing would reveal that this transaction was unlikely to have been caught by the provisions of the Companies Act, 1965. As the former director was no longer a director of the company at the time of the transaction, Section 132E would not be applicable. The Section deals with disposals made to directors of the company, and does not include persons who were recently directors of the company.<sup>4</sup>

Section 137 would also not apply to this transaction as the Section deals with payments made to a director. Although, subsection (4) refers to any valuable consideration given to a director, it appears to apply only to situations where a director's office is abolished or he retires in connection with a transfer of all or any of the shares of the company as a result of an offer made to shareholders.

As for the fiduciary rules, whether the no-profit rule would extend to this situation would depend on how the rule is interpreted. If the stricter interpretation for which *Regal (Hastings) Ltd v Gulliver*<sup>5</sup> has been cited as authority is followed, arguably this transaction would not be caught by the no-profit rule. The person in question here was no longer a director at the time of the transaction. Accordingly, the implied temporal limitation of the no-profit rule espoused in *Regal Hastings* would relieve the former director from the obligation to account for a profit, as he had resigned from the fiduciary office prior to the time of the transaction.<sup>6</sup> However, according to the more liberal interpretations of the no-profit rule as reflected in the cases of *Industrial Development Consultants v Cooley*<sup>7</sup> and *Canadian Aero Service Ltd v O'Malley*,<sup>8</sup> the former director may arguably be required to account for any profit made. Once again, it

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<sup>4</sup> In contrast, the Australian provisions include persons who were directors at any time within the previous six months; Section 243F(2) of the Corporations Law (Australia).

<sup>5</sup> [1942] 1 All ER 378.

<sup>6</sup> Ford, H.A.J. and Austin, R.P., Principles of Corporations Law, (7th edition, 1995), 320.

<sup>7</sup> [1972] 2 All ER 162.



is shown that the uncertainty surrounding the application of the fiduciary principle causes difficulty both for the shareholders as well as the fiduciary in discerning the limits of their respective rights and obligations.

### **6.3 E Berhad's Acquisition of Land from F Sdn Bhd**

Another transaction involved the acquisition of land by E Berhad from F Sdn Bhd. The land was purchased by E Berhad for a few million ringgit. Both companies had common directors. The sale was subsequently aborted.

One of the grounds on which the transaction was criticised was that it could have been construed as a loan to one of the directors. It was noted that an unusually large proportion of the purchase price was paid to F Sdn Bhd as a deposit for the purchase. Further, despite the fact that the deal was subsequently aborted, F Sdn Bhd was unable to repay most of the deposit to E Berhad. A loan had also been made by F Sdn Bhd to one of the directors. Consequently, the transaction was alleged to be a camouflaged loan to the director.

The concern over self-dealing arose mainly in relation to E Berhad, E Berhad being the public company with minority shareholders. However, E Berhad encountered a number of obstacles in pursuing remedies against its directors.

As regards the statutory provisions on self-dealing, the transaction would not come within the ambit of Sections 133 and 133A of the Companies Act, 1965 (Act 125). Both the Sections apply to loans to a director or persons connected with a director. They also include the giving of guarantees or securities in connection with a loan made

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<sup>8</sup> (1973) 40 DLR (3d) 371.

to such persons. However, these Sections are unlikely to be construed as including arrangements which amount to indirect loans to directors or persons connected with directors, such as the alleged loan in question.

In order for the transaction to be caught by Section 132E of the Companies Act, 1965 (Act 125), the property must be of the requisite value. As the land was purchased for a few million ringgit, the property was of the requisite value. This is regardless of which of the amounts stated in Section 132E(5) is taken as the threshold amount. The purchase price of the land clearly exceeded RM250,000 and 10% of E Berhad's asset value.

Further, in order to be caught by Section 132E, it must be shown that F Sdn Bhd was a body corporate connected with a director of E Berhad. This may be shown in a number of ways. The first method would be to show that the director had a controlling interest in F Sdn Bhd at the time of the transaction. Alternatively, it may be shown that F Sdn Bhd was accustomed to act in accordance with the directions of a director of E Berhad. The third alternative would be to show that the director or persons connected with him were entitled to exercise the votes of not less than 15% of the votes in F Sdn Bhd. However, it appears that such information may not be readily available to shareholders who are not involved in the management of the companies concerned.

As for Section 132G, it is difficult to ascertain whether the Section is breached without information relating to the length of time that F Sdn Bhd had held the land in question. Similarly, information regarding the shareholding of the directors in F Sdn Bhd would be essential in proving a breach of Section 132G. However, information of this kind may often not be readily available to the public. Considerable efforts may often have to be made in order to procure such particulars.



Nevertheless, the no-conflict rule is likely to preclude the directors from acting in a manner which will bring personal interest into conflict with that of the company. As seen in *Guinness v Saunders*,<sup>9</sup> the no-conflict rule is applied strictly. In this situation, there was a director of E Berhad who was also a director and substantial shareholder of F Sdn Bhd at the time of the transaction. In addition, F Sdn Bhd had given him a loan. Accordingly, there would appear to be a real and sensible possibility of conflict between the interest of E Berhad and the director's personal interest.

#### 6.4 Conclusion

The examination of the above transactions illustrate some of the shortcomings of the rules regulating self-dealing by directors. Firstly, the fiduciary duties were wide enough to catch various situations of self-dealing that were not caught by statute. However, the uncertainties in the interpretation and application of the fiduciary principles gave rise to problems. It remains relatively uncertain how strictly the rules should be construed, and how wide or narrow the ambit of the rules are.

The statutory provisions, on the other hand, are specific and certain. The disadvantage of these provisions is that in being specific, they fail to address various situations of self-dealing, such as where the director has recently retired, or where other forms of consideration, besides monetary payments, are given to a director upon his retirement.

A further problem encountered in examining transactions potentially involving self-dealing by directors is the difficulty of procuring the necessary information to ascertain whether the directors' duties have been breached. Some information is not readily

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<sup>9</sup> [1990] 2 WLR 324.

available to the public or those not involved in the management of the company.<sup>10</sup> This includes information such as the net tangible asset value of the company, and the length of time property has been held by companies, or whether the relevant persons hold the requisite shareholdings. Some of these details may be determined if additional measures are taken or investigations are conducted to procure information, such as searches on companies. However, the trouble of taking such measures, coupled with the ignorance of many shareholders on the legal rules governing self-dealing may result in dissatisfied shareholders selling their shares instead of confronting the directors with their breaches of duty.

In addition to the above, another obstacle faced by aggrieved shareholders, particularly by minority shareholders, is the ratification of transactions involving self-dealing by directors. This issue will be addressed in greater detail in Chapter 7.

Finally, shareholders, especially minority shareholders, are hindered from enforcing their rights against errant directors by the rule in *Foss v Harbottle*.<sup>11</sup> This rule requires actions against errant directors for breaches of directors' duties to be brought by the company. This issue will also be examined in greater detail in Chapter 8, together with the discussion on the remedies available for breaches of directors' duties.

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<sup>10</sup> Shareholders may at times need to run an audit of the company in order to prove breaches of duty; Barrock, L., 'The unfortunate minorities', *The Edge*, 18 September 2000. It is also noted that some improprieties have been highlighted by the Securities Commission or the Kuala Lumpur Stock Exchange, who issued public reprimands of the companies concerned. However, even with these public reprimands, some of which included penalties paid by the companies,



The law does not impose the liability of directors in respect of self-dealing for the purpose of the company's business. The liability is more than a fiduciary obligation in that it is a liability to the company. In respect of the fiduciary principle, it is recognised that the duty of directors is to the company. The primary obligation owed to the company is that of loyalty. This duty of a director may be breached in a number of ways.

1. A director may be liable for breach of the fiduciary principle if he or she is in a position of conflict of interest. The company may require a director to disclose any such conflict of interest. If a director fails to do so, he or she may be liable for breach of the fiduciary principle. 2. A director may be liable for breach of the fiduciary principle if he or she is in a position of conflict of interest. The company may require a director to disclose any such conflict of interest. If a director fails to do so, he or she may be liable for breach of the fiduciary principle. 3. A director may be liable for breach of the fiduciary principle if he or she is in a position of conflict of interest. The company may require a director to disclose any such conflict of interest. If a director fails to do so, he or she may be liable for breach of the fiduciary principle.

The general principle of self-dealing is that a director must not place himself in a position where his personal interests conflict with the interests of the company. This principle is subject to certain exceptions. For example, a director may be allowed to enter into a transaction with the company if the transaction is approved by the shareholders. The company must have knowledge of the transaction and the director must disclose the transaction to the shareholders. If the transaction is approved by the shareholders, the director will not be liable for breach of the fiduciary principle.

further information on the self-dealing by directors was not readily available to facilitate action against them by dissatisfied shareholders.

<sup>11</sup> (1843) 2 Hare 461.

## C CHAPTER 7 - RATIFICATION

In previous chapters, the liability of directors in respect of self-dealing has been discussed. This liability stems from equitable fiduciary principles as well as from statute. As regards the fiduciary principles, it is recognised that directors may be released from the fiduciary obligations owed to the company.<sup>1</sup> The authority to grant such a release is vested in the company. This release of a director from fiduciary obligations is known as ratification.<sup>2</sup>

Ratification of a director's actions may be made either prospectively or retrospectively.<sup>3</sup> Accordingly, the company may approve or ratify in advance the actions of directors which would amount to a breach of fiduciary obligations to the company. Alternatively, ratification of the directors' actions may be made after such a breach has occurred. Whether ratification is made before or after the event, the result of such ratification is to release or absolve the director from liability for his breach of fiduciary duty.

The essential elements of ratification are, firstly, the adoption by the company of the transaction which is entered into in breach of fiduciary duties. Secondly, in ratifying the breach, the company must have knowledge of the relevant facts surrounding the breach.<sup>4</sup> Accordingly, ratification of directors' breaches of fiduciary duty would only be permissible subject to the condition that full and frank disclosure of the material facts is made to the company in advance of the decision to ratify the breach.<sup>5</sup>

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<sup>1</sup> Davies, P.L., Gower's Principles of Modern Company Law, (6th edition, 1997), 644-5.

<sup>2</sup> Ford, H.A.J. and Austin, R.P., Principles of Corporations Law, (5th edition, 1990), 489.

<sup>3</sup> *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

<sup>4</sup> *Goh Kim Hai Edward v Pacific Can Investment Holdings Ltd* [1996] 2 SLR 109, 135.

<sup>5</sup> *Bank Bumiputra Malaysia Berhad v Lorrain Esme Osman* [1987] 1 MLJ 502.



Ratification by the company of the actions of its directors has a twin effect. In *Fong Poh Yoke v The Central Construction Company (Malaysia) Sdn Bhd*,<sup>6</sup> it was remarked that ratification causes the company to be bound by the transaction which would otherwise be voidable due to the breach of the director's duty.<sup>7</sup> Secondly, ratification operates to release the directors from their liability for breach of fiduciary duty.<sup>8</sup>

Apart from the basic principles outlined above, the issue of ratification involves various complexities. Hence the ratification of breaches of directors' duties has been described as one of the most difficult legal issues.<sup>9</sup> For instance, where directors are in breach of their fiduciary duties, it is clear that the company is the appropriate body to ratify the actions of the directors. However, the issue as to who should represent the company as regards such ratification is fraught with difficulty.

## 7.1 Who Can Ratify?

### 7.1.1 The General Meeting

The company in general meeting is usually regarded as having the authority to ratify breaches of fiduciary duty by directors.<sup>10</sup> Where the general meeting acts unanimously, it is clear that they can ratify breaches of fiduciary duty.<sup>11</sup> It is not as clear whether the general meeting can by a simple majority ratify such breaches. This issue is complicated by the general principle that a director can vote as a shareholder even in

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<sup>6</sup> [1998] MLJU 478.

<sup>7</sup> See also Ford, *supra* note 2, 485.

<sup>8</sup> *Fong Poh Yoke v The Central Construction Company (Malaysia) Sdn Bhd* [1998] MLJU 478; *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136; Davies, *supra* note 1, 645.

<sup>9</sup> Neilson, F. and Goodman, D., *Liability of Corporate Officers*, (1988), 38; Beck, S.M., 'The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered' (1971) 49 *Can Bar Rev* 80, 114.

<sup>10</sup> *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

matters in which the director has an interest.<sup>12</sup> Hence, if a breach may be ratified by a simple majority of the general meeting, directors commanding more than 50% of the votes in a company would be able to ratify their own breaches of duties to the company. This would permit the wrongdoers to absolve themselves of liability for their wrongdoing, which is a rather unsatisfactory position.<sup>13</sup>

The issue of ratification of transactions involving directors' interests was canvassed briefly in *Re Kong Thai Sawmill (Miri) Sdn Bhd*.<sup>14</sup> The court appeared to indicate that a simple majority of the general meeting can ratify these matters. However, this is subject to the condition that the majority shareholders do not take advantage of their voting powers and grant themselves benefits in complete disregard of the interest of other shareholders.

Such a situation was encountered in *Cook v Deeks*.<sup>15</sup> In *Cook v Deeks*, resolutions were passed approving a transaction which was entered into by some of the directors in breach of the no-profit rule. This transaction involved an appropriation of a corporate opportunity for the benefit of some of the directors. The resolutions in question were passed by the company, owing to the voting power held by the directors who were in breach of their fiduciary duties. Hence, the resolution was approved by the company despite the objections of the minority.

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<sup>11</sup> Farrar, J.H. and Hannigan, B.M., *Farrar's Company Law*, (4th edition, 1998), 424; *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] 2 All ER 1222; *Parker v McKenna* (1874) 10 Ch App 96.

<sup>12</sup> *Tuan Haji Ishak bin Ismail v Leong Hup Holdings Berhad* [1996] 1 MLJ 661; *Guyler Magruder v Creative Software (M) Sdn Bhd* [1994] MLJU 107; *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

<sup>13</sup> Farrar, *supra* note 11, 424; *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* per Vinelott J [1980] 2 All ER 841, 862.

<sup>14</sup> [1976] 1 MLJ 59.

<sup>15</sup> [1916] AC 554.



The Privy Council, however, disallowed such resolutions. In the judgment delivered by Lord Buckmaster, his Lordship remarked the directors holding a majority of shares would not be permitted to make a present to themselves, as this would allow the majority to oppress the minority.

From the above, it would appear that there is some support for the proposition that ratification of breaches of fiduciary duty may be made by a majority of shareholders, with the directors who are in breach exercising their voting rights as shareholders to ratify such breaches. Nonetheless, this is subject to the condition that the majority shareholders should not take advantage of their voting power to grant benefits to themselves in complete disregard of the interest of other shareholders.

### 7.1.2 *The Board of Directors*

It is even more doubtful whether the board of directors can ratify breaches of fiduciary duty by a director.<sup>16</sup> Even if the directors in breach of fiduciary duty abstain from voting, it is foreseeable that the other directors may be tempted to take a more lenient view of the breach than shareholders would. This is so, particularly as these directors may be hoping for similarly lenient treatment if they should breach their duties at a future time.

The case of *Queensland Mines Ltd v Hudson*<sup>17</sup> may arguably be regarded as a decision in which the board of directors ratified a breach of the no-profit rule. In *Queensland Mines* the director who made a profit by exploiting a corporate opportunity was held not liable for breach of fiduciary duty. There was no shareholder approval or

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<sup>16</sup> Cranston, R., 'Limiting Directors' Liability: Ratification, Exemption and Indemnification', [1992] *Journal of Business Law* 197, 202; Yeung, K., 'Disentangling the Tangled Skein: The Ratification of Directors' Actions', (1992) 66 *ALJ* 343, 356-7; *Winthrop Investments v Winns Ltd* [1975] 2 NSWLR 666, per Mahoney J.

ratification of the breach of duty. Instead, the board of directors had renounced the company's interest in the venture and assented to the director's exploitation of the opportunity. The Privy Council held that the director was not liable for any breach of fiduciary duty, despite the fact that there was no ratification by the shareholders approving the breach of the no-profit rule.

A similar decision was reached in *Peso Silver Mines Ltd v Cropper*.<sup>18</sup> However, these decisions may be regarded as part of the law peculiar to corporate opportunity. It is possible that there was no breach of fiduciary duty in those cases as the company had rejected the corporate opportunities.<sup>19</sup> Alternatively, the approval of the board of directors in *Queensland Mines* could also be seen as the unanimous approval of shareholders, as both shareholders were represented on the board of directors.<sup>20</sup>

### **7.1.3 Should Directors be Allowed to Vote at General Meetings to Ratify their Breaches?**

As mentioned earlier, one of the issues which is the cause of much dissatisfaction is the issue of a director exercising his vote as a shareholder to ratify his breach of fiduciary duty. The general principle is that votes are proprietary rights, and consequently, a shareholder may exercise his voting rights in any way he wishes.<sup>21</sup> This includes voting in his self-interest, even if it is opposed to the company's interest. Clearly, this is problematic where the breach of directors' duties is concerned, especially if a company can ratify directors' breaches of duty by a simple majority. In such a situation, directors

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<sup>17</sup> (1978) 52 ALJR 399.

<sup>18</sup> (1966) 58 DLR (2d) 1.

<sup>19</sup> Cranston, *supra* note 16, 202-3; Farrar, *supra* note 11, 425.

<sup>20</sup> This is discussed in greater detail in Section 4.2 of Chapter 4.

<sup>21</sup> *Tuan Haji Ishak bin Ismail v Leong Hup Holdings Berhad* [1996] 1 MLJ 661; *Guyler Magruder v Creative Software (M) Sdn Bhd* [1994] MLJU 107; *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589; *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133.



holding the majority of votes could absolve themselves of liability for breach of duty to the company.

Not surprisingly, there have been suggestions that directors should be prevented from voting in relation to breaches of their duties. The Australian Companies and Securities Law Review Committee took the view that directors should not vote to ratify breaches of their duties.<sup>22</sup> The Committee reasoned that fairness requires that the person who will be relieved should not consent to his or her wrong. Section 243ZF of the Corporations Law (Australia) disqualifies directors from voting at a general meeting to ratify transactions from which they would receive a financial benefit. A similar view has been adopted by various commentators, who have suggested that it is better to require an independent or disinterested group of shareholders to ratify breaches of directors' duties.<sup>23</sup>

In Malaysia, the Finance Committee on Corporate Governance has similarly suggested that statutory provisions should be enacted to address the issue of directors voting as shareholders. In the Report on Corporate Governance, the Committee proposed that statutory provisions should be enacted to provide that directors interested in the subject matter of the resolution should refrain from voting as shareholders in respect of that resolution.<sup>24</sup>

It appears to be prudent to disallow directors' votes in favour of resolutions which relieve directors from liability. It is clear that where a resolution to absolve a director from liability is involved, the director would vote in his self-interest to absolve himself

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<sup>22</sup> Companies and Securities Law Review Committee, Discussion Paper No. 9: Company Directors and Officers: Indemnification, Relief and Insurance, 1989.

<sup>23</sup> Baxt, R., 'Judges in Their Own Cause: the Ratification of Directors' Breaches of Duty', (1978)

<sup>5</sup> MonLR 16; Beck, *supra* note 9, 119.

from liability. Allowing such directors to vote in relation to resolutions to affirm impugned transactions is akin to allowing such directors to bind the company to the impugned transaction, regardless of whether the same is beneficial to the company. Such a resolution could impose hardship on the company, and be prejudicial to the interest of the company.

Nevertheless, there are a number of setbacks to disallowing directors from voting to ratify their breaches of duty. Firstly, where the directors hold the majority of votes, a blanket prohibition on directors voting as shareholders in such matters would empower the minority to dictate the company's actions despite the majority's preferred course of action.<sup>25</sup> Further, restricting directors from voting as shareholders would be difficult to reconcile with the fundamental principle that shareholders' voting rights are proprietary rights, which may be exercised in any way the shareholders wish.<sup>26</sup> Clearly, the issue of whether directors should be entitled to vote to ratify their breaches of duty is one which requires careful consideration. As such, this issue will be further discussed in Section 7.4 below.

#### **7.1.4 Minority Shareholders: Practical Considerations**

Underlying the ratification of directors' breaches of duty is the basic principle that all shareholders who have voting rights attached to their shares would generally have the right to vote at a general meeting. Nonetheless, there are practical considerations which hinder shareholders from exercising their voting rights. These impediments are likely to be of particular significance to minority shareholders of public companies.

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<sup>24</sup> Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 154.

<sup>25</sup> *Ibid.*

<sup>26</sup> It is noted that there is some Australian support for the proposition that shareholders should be governed by a duty to act for proper purposes; *Ngurli Ltd v McCann* (1953) 90 CLR 425.



As discussed in earlier chapters, the separation between ownership and control is especially marked in minority shareholders of public companies. Minority shareholders are frequently excluded from the management of the company, and have limited access to information on the company's dealings.<sup>27</sup> Details regarding the breach of directors' duties that is sought to be ratified may not often be readily available.<sup>28</sup> The only information readily available may be the information which the directors choose to disclose at the general meeting. Many of these shareholders hold shares as part of a diversified portfolio. Hence, they may be disinclined to take the trouble of seeking out the details of the transaction, and may consider the benefit of becoming informed as minimal.<sup>29</sup> As such, these minority shareholders may be disinclined to exercise their voting rights.

A further reason why minority shareholders would be disinclined to vote would be the perception that in many situations, the minority shareholders' votes would make little difference to the outcome of the resolution.<sup>30</sup> The controlling shareholder may have garnered enough votes to secure the necessary approval.<sup>31</sup> Moreover, in order for the other shareholders to make a difference, there may need to be collective action among the minority shareholders.<sup>32</sup> This may be difficult to obtain, particularly in large public

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<sup>27</sup> Miles, L. and Proctor, G., 'Unresponsive shareholders in public companies: dial "M" for motivate?', (2000) 21 The Company Lawyer 142, 143.

<sup>28</sup> Professor Farrar observes that the suspect transactions are often of a complicated financial nature which the shareholder cannot easily unravel. It may be difficult to establish precisely what the transaction involves and who are the beneficiaries. The board would also usually refuse to disclose information when questioned at the general meeting; Farrar, *supra* note 11, 429.

<sup>29</sup> Whincorp, M.J., 'An Economic Analysis of the Criminalisation and Content of Directors' Duties', (1996) 24 Australian Business Law Review 273, 277.

<sup>30</sup> Griffiths, A., 'Shareholding and the Governance of Public Companies', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 61; Miles, *supra* note 27, 143.

<sup>31</sup> See for instance Lee, S.L., Taing, A., 'Showdown at UEM', The Edge, 9 February 1998, where the minority shareholders were of the opinion that the outcome of the Extraordinary General Meeting was a foregone conclusion. Similarly, in Barrock, L., 'The unfortunate minorities', The Edge, 18 September 2000, it was remarked that sometimes it is obvious that at a general meeting of shareholders, the majority shareholders can bulldoze proposals through.

<sup>32</sup> Griffiths, *supra* note 30, 61.

companies which have large numbers of minority shareholders, each with small shareholdings.<sup>33</sup>

Given the practical difficulties in influencing the shareholders' resolution, minority shareholders who are dissatisfied with the company's dealings are likely to resort to selling their shares instead.<sup>34</sup> Nevertheless, shareholders are able to influence the board of directors and the management of the company through their ability to sell their shares. In particular, the sale of shares can affect the company's share price, with consequent adverse publicity.<sup>35</sup> This power to sell one's shares is seen as an important counter-balance to the discretionary power of the management of a public company, and is known as the 'market in corporate control'.<sup>36</sup>

## 7.2 What Can Be Ratified?

Not all breaches of fiduciary duty are ratifiable by the company. Identifying the limits to the shareholders' power to ratify breaches of fiduciary duty is not a simple task. A frequently accepted principle is that shareholders may not misappropriate the company's property for themselves.<sup>37</sup> The company's property is held in common by all shareholders of the company. As such, the majority cannot take the company's property in disregard of the other shareholders' interest in the property. It follows that breaches

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<sup>33</sup> *Ibid.*

<sup>34</sup> Miles, *supra* note 27, 143.

<sup>35</sup> Griffiths, *supra* note 30, 62.

<sup>36</sup> *Id.* 61. See for example Long, H.C., 'UEM Fined RM100,000 over Renong purchase', New Straits Times, 19 February 1998, in which it was reported that shareholders sold their shares in reaction to the perceived bailout at the expense of minority shareholders, causing the stock market to react badly.

<sup>37</sup> Cranston, *supra* note 16, 200; Ford, *supra* note 2, 489; Davies, *supra* note 1, 646.



which are generally regarded as being non-ratifiable are breaches which involve a fraud on the minority or misappropriation of the company's property.<sup>38</sup>

A case which involved misappropriation of the company's property is *H. Rosen Engineering B.V. v Siow Yoon Keong*.<sup>39</sup> In *Rosen Engineering*, a director used the company's funds to invest in shares. When he realised that he was about to incur a loss, he arranged for the company to ratify the transaction, on the ground that the investments were made by him on behalf of the company. The court held that the ratification did not make his unauthorised use of the funds proper. Notwithstanding the ratification, he was found to be in breach of his fiduciary duties.

Where directors procure the ratification by the company of excessive remuneration for directors, such ratification may also be invalid. This is because excessive remuneration may constitute misappropriation of the company's property or fraud on the minority.<sup>40</sup>

In *Re Kong Thai Sawmill (Miri) Sdn Bhd*,<sup>41</sup> it was remarked that a court would not normally interfere with directors' fees and bonuses fixed by the general meeting. Nonetheless, where excessively high amounts are approved by the majority shareholders at a general meeting in disregard of the interest of other shareholders, the court may intervene, despite ratification by the general meeting. The court remarked that majority shareholders should not take advantage of their voting powers to fix high bonuses for themselves as directors.

In *Yukilon Manufacturing Sdn Bhd v Dato' Wong Gek Meng (No. 4)*,<sup>42</sup> some of the directors diverted the business of Company A to Company B, which was owned by

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<sup>38</sup> *Ibid.*

<sup>39</sup> [1997] 1 CLJ 137.

<sup>40</sup> Cranston, *supra* note 16, 201

<sup>41</sup> [1976] 1 MLJ 59.

<sup>42</sup> [1998] 7 MLJ 551.

them personally. They then proceeded to stop Company A's manufacturing operations in breach of their fiduciary obligations to Company A. The directors procured a resolution of Company A in general meeting, ratifying Company A's cessation of manufacturing operations. Nevertheless, the purported ratification was found to be ineffective. Arguably, the directors' breach of duties amounted to a fraud on the minority, and the diversion of business was a misappropriation of the company's business.

Similarly, *Cook v Deeks*<sup>43</sup> was a case in which the exploitation of corporate opportunity by directors was found to be non-ratifiable. In *Cook v Deeks*, the Privy Council took the view that the directors holding the majority of votes would not be permitted to make a present to themselves, as it would allow the majority to oppress the minority. Thus, a resolution that the rights of the company should be disregarded in the matter would amount to forfeiting the interest and property of minority shareholders in favour of the majority.<sup>44</sup> This would amount to a fraud on the minority, and would thus be non-ratifiable.<sup>45</sup>

In contrast to *Cook v Deeks* and *Yukilon*, the courts have considered the exploitation of corporate opportunity by the directors in *Regal (Hastings) Ltd v Gulliver*<sup>46</sup> and *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*<sup>47</sup> to be ratifiable. The cases of *Cook v Deeks* and *Regal Hastings* have been acknowledged as being difficult and perhaps even impossible to reconcile.<sup>48</sup> It has been suggested that a distinction may be made between misappropriation of the company's property and merely making an incidental profit for

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<sup>43</sup> [1916] AC 554.

<sup>44</sup> This principle was applied in *Ng Pak Cheong v Global Insurance Co Sdn Bhd* [1995] 1 MLJ 64.

<sup>45</sup> *Cook v Deeks* [1916] AC 554; *Menier v Hooper's Telegraph Works* (1874) LR 9 Ch 350.

<sup>46</sup> [1942] 1 All ER 378.

<sup>47</sup> [1980] 2 MLJ 136.

<sup>48</sup> Davies, *supra* note 1, 647.



which the directors are liable to account to the company.<sup>49</sup> *Cook v Deeks* would come within the first category. It has been suggested that the directors in *Regal (Hastings)* did not misappropriate any property of the company but merely made an incidental profit from the information acquired as directors.<sup>50</sup>

Arguably, a corporate opportunity is part of the property of the company. Accordingly, based on that reasoning, the taking of a corporate opportunity would amount to a misappropriation of property belonging to the company. The main difference between the facts in *Cook v Deeks* and *Yukilon* on one hand, and *Regal (Hastings)* and *PJTV Denson* on the other hand, appears to be the fact that in *Cook v Deeks* and *Yukilon*, the companies wanted the opportunities, whereas in *Regal (Hastings)* and *PJTV Denson*, the companies could not exploit the opportunities. As seen in Chapter 4, the inability of the company to exploit a corporate opportunity does not preclude a director's exploitation of that opportunity from being a breach of fiduciary duty. Perhaps the distinguishing factor is the lack of bona fides on the part of the directors in *Cook v Deeks* and *Yukilon*. This, in turn, appears to be reflective of the basic fiduciary principle that a director should act bona fide for the benefit of the company, and not for an improper purpose.

Where tangible property is misappropriated by directors who are also the majority shareholders, such misappropriation is likely to be a fraud on the minority, as it would deprive the other shareholders of the property. With intangible property, such as information or corporate opportunity, the use of the same by directors may not always be detrimental to the minority.<sup>51</sup> Perhaps the dividing line between ratifiable and non-ratifiable breaches should be drawn so as not to exclude misappropriation of property

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<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

*per se* from ratification. Instead, it is suggested that the deciding factor should be the misappropriation of the company's property where the same is made *mala fide* or in disregard of other shareholders' interests in the property.

### 7.3 Ratification of Breaches of Statutory Duty

Aside from equitable fiduciary duties, directors are also subject to statutory duties relating to self-dealing. Accordingly, the question also arises as to whether breaches of statutory duty by directors can be ratified. Generally, it is conceded that breaches of statutory duty cannot be ratified at common law in the same manner as breaches of fiduciary duty.<sup>52</sup> However, ratification would be possible where the statutory provision breached provides for ratification of actions in breach of the statutory duty.

Such ratification is provided for in Section 132E of the Companies Act, 1965 (Act 125). Section 132E(2) stipulates that an arrangement or transaction entered in contravention of Section 132E(1) may be ratified by the company in general meeting. As a consequence of such ratification, the arrangement or transaction which is voidable as a result of the contravention will be binding on the company. In addition, subsection (2) also requires ratification by a resolution of the holding company in general meeting where the arrangement or transaction is for the transfer of an asset to or by a director of the holding company.

Breaches of statutory duty can also result in criminal liability for directors. The cases of *Yeow Fook Yuen v Regina*<sup>53</sup> and *Public Prosecutor v Yeoh Teck Chye & Lim Hong*

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<sup>51</sup> *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

<sup>52</sup> Cranston, *supra* note 16, 201.

<sup>53</sup> [1968] 2 MLJ 80.



*Peng v Public Prosecutor*<sup>54</sup> make it clear that a director cannot be released from criminal liability by ratification by the company of such a breach.

It would seem to be rather incongruous that breaches of fiduciary duty may be ratified, but liability under statute should remain in respect of the same matter. Consequently, even where the company has absolved its directors of their breaches of fiduciary duty to the company, the directors may be liable to statutory penalties in respect of the same acts. In certain situations, the company may choose to ratify a director's breach of duty on grounds that he may have been acting honestly. However, under the statutory provisions, even where a director may have been honest and unaware of the contravention due to no fault of his own, the director may nevertheless be subject to criminal penalties.<sup>55</sup>

Despite the incongruous result, there is arguably at least one positive effect of the anomaly discussed above. Ratification of breaches of fiduciary duty may at times have the effect of trivialising fiduciary duties, particularly where wrongdoers ratify their own breaches. The fact that wrongdoers cannot absolve themselves of liability under statute would counter that effect of ratification. Consequently, the statutory penalties may operate to lessen abuse by wrongdoers of their voting rights. This is due to the fact that their attempts to ratify their wrongs would often not absolve them of liability arising under statute.

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<sup>54</sup> [1981] 2 MLJ 176.

<sup>55</sup> See for instance Section 132E and Section 133 of the Companies Act, 1965 (Act 125). This was discussed in greater detail in Chapter 5.

## 7.4 Concluding Remarks

Directors' fiduciary duties seek to prevent directors from dealing with the company's property as if it were their own property. Inherent in these principles is the recognition that the property of the company belongs to the company as a whole. The company, in turn, is owned by the shareholders collectively. These principles operate for the protection of the shareholders who are not represented on the board of directors, and in particular, the minority shareholders.

The question as to whether the fiduciary principles effectively protect the interests of these shareholders is significantly influenced by the issue of ratification. If wrongdoers are able to ratify their wrongs by exercising the majority of voting rights in the company, this would erode the protection afforded by fiduciary principles to the shareholders as a whole. Those particularly affected would be the minority shareholders.

A certain degree of protection is given to these shareholders by the principle that a fraud on the minority cannot be ratified. However, challenging a resolution which has been passed by the company, on the ground that it amounts to a fraud on the minority, is likely to be cumbersome as well as costly for minority shareholders. Allowing wrongdoers to vote at a general meeting to ratify their breach of duty, except where such a breach amounts to a fraud on the minority, places the burden of proving fraud on the minority and enforcing fiduciary principles on the minority shareholders. These minority shareholders are generally at a greater disadvantage in proving fraud on the minority, especially as they are frequently not privy to information on the internal workings of the company.



Instead, it is submitted that the burden of showing that there has been no fraud on the minority should be placed on the directors, who are in control of the company, and hence, have greater access to information concerning the company. Further, since the directors' breach of fiduciary duties is in question, it would seem fair to require these directors to prove that their breach does not also amount to a fraud on the minority.

Consequently, it is submitted that where directors wish to vote as shareholders to ratify their own breach of duty, they should first show that the breach does not amount to a fraud on the minority.<sup>56</sup> Otherwise, they should not be permitted to vote. (For the purposes of this Section, the shareholders who are also the directors in breach of their fiduciary duties shall be referred to as "shareholder-directors".) This proposition has similarities to the various suggestions, discussed in Section 7.1.3, that shareholder-directors should not be permitted to vote to ratify breaches of their duties, and that ratification of breaches of directors duties should be by an independent group of shareholders. As mentioned, there are two objections to the proposition that breaches of directors duties should be ratified by independent shareholders. The first objection is the established principle that shareholders' voting rights are proprietary rights. And the second objection is that this may result in rule by the minority instead.

Nonetheless, the suggestion that shareholder-directors should first show that the breach does not amount to a fraud on the minority, before being permitted to vote, is not an absolute prohibition. As long as they can show that there has been no fraud on the minority, they will be permitted to vote. Hence, this lessens the likelihood of rule by the minority. The

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<sup>56</sup> 'Fraud on the minority' involves the majority of members in a company exercising their voting power beyond the scope of that power in such a way so as either to expropriate the company's property or members' property. The essence of the matter seems to be an abuse or misuse of power to benefit

principle that shareholders' voting rights are proprietary rights, which may be exercised in any way the shareholders wish, is however, a greater obstacle. It is arguable that although voting rights are proprietary rights, nonetheless they may not be abused to ratify a fraud on the minority. Requiring the shareholder-directors to show that there is no fraud on the minority, as a prerequisite to their voting, is arguably an extension of that argument.

A related issue is the question of whether the prerequisite of showing that there has been no fraud on the minority should be limited only to shareholder-directors. In some cases, the directors may not themselves be shareholders. Instead, they may be nominees of corporate bodies who are shareholders. At times, the benefit of the transactions which are in breach of fiduciary duty may be conferred on a related party, who may also be a shareholder. It is questionable whether these other parties should also be precluded from voting to ratify the breaches of fiduciary duty, unless they can show that there is no fraud on the minority. Also related to this issue is the question of whether the criteria for determining whether shareholders are interested in the breach of duty should be based on relationship with the director in breach or benefit from the transaction, or both.

It may be fairly easy to identify the shareholder-directors who are in breach of fiduciary duties and prevent them from voting. Identifying the other categories of shareholders is likely to be more difficult. It may be possible to identify whether a director is a nominee of a shareholder or a group of shareholders. Nevertheless, it is likely to be less obvious who related parties are, particularly to a minority shareholder who may not have access to much information concerning the company and its shareholders. Similarly, identifying the persons

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themselves at the company's expense; per Megarry V-C in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.



who benefit from the transaction may be difficult, especially where the transaction is made through layers of nominees.

There is yet another weakness to the proposition that shareholder-directors should first show that there is no fraud on the minority before being permitted to vote. This arises from the fact that merely requiring these shareholder-directors to prove to the general meeting that there has been no fraud on the minority may not be much of a deterrent against abuse. In particular, where the shareholder-directors are aware that the minority shareholders have little ability to enforce their rights, the shareholder-directors may pay little attention to the requirement. One means of giving such a requirement greater weight would be to provide for statutory penalties for contravention. As discussed in Section 7.3, statutory provision of penalties would appear to have the effect of reducing the potential for abuse.

In conclusion, restricting the voting rights of shareholder-directors appears to be an important and necessary means of ensuring that fiduciary duties maintain their effectiveness. However, as mentioned earlier, this runs counter to the established principle that voting rights are proprietary rights, and shareholders should essentially be entitled to vote in any way they wish. Further, there appears to be some hesitance in restricting the voting rights of shareholder-directors for the reason that Article 13(1) of the Federal Constitution preserves the right to property.<sup>57</sup> As such, despite the need for the restriction of voting rights, overcoming the reluctance to interfere with voting rights may prove to be rather problematic. Arguably, the wording of Article 13(1),<sup>58</sup> may allow for a statutory amendment which

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<sup>57</sup> The case of *Government of Malaysia v Selangor Pilot Association* (1946) [1977] 1 MLJ 133 suggests that negative or restrictive provisions can deprive a person of property for the purposes of Article 13(1) of the Federal Constitution; A.J., Harding, 'Property Rights under the Malaysian Constitution', In *Constitution of Malaysia: Further Perspectives and Developments*, (Ed. Harding, F.A. and Lee, H.P.), (1986).

<sup>58</sup> Article 13(1) states that "No person shall be deprived of property save in accordance with law".

restricts shareholder-directors from voting in situations which would amount to an abuse of voting rights. However, it remains to be seen whether this fundamental right to property will be regarded as being so unshakeable as to prevent any restrictions or conditions to the exercise of voting rights in order to prevent abuse of voting rights.



## CHAPTER 8 – RELIEF AND REMEDIES

### 8.1 Relief

As seen in Chapter 7, directors may seek to be relieved from liability for breaches of their fiduciary duties through ratification of the breach by the company. However, as discussed in Chapter 7, not all breaches of directors' duties may be ratified. One type of breach which cannot be ratified by the company is a breach of statutory duties. In such situations, the directors may seek relief from liability under Section 354(1) of the Companies Act, 1965 (Act 125).

Relief from liability under Section 354(1) of the Companies Act, 1965 (Act 125) is not confined only to liability for breaches of statutory duties. Directors who have breached their fiduciary duties may also apply for relief under this Section. Pursuant to this Section, the courts have power to grant to directors relief from liability. The power to grant relief is exercisable on three requirements being met. It appears that the burden of proving these three requirements falls on the director.<sup>1</sup>

These three requirements are, firstly, that the director must have acted honestly. Secondly, the director must show that he acted reasonably. Thirdly, it must be shown that he ought fairly to be excused, having regard to all the circumstances of the case. Whether a director has acted honestly and reasonably is a question of fact.<sup>2</sup> Accordingly, these issues should not be determined summarily. Justice requires that the

<sup>1</sup> *Simmah Timber Industries Sdn Bhd v David Low See Keat* [1999] 5 MLJ 421, 437; Woon, W., *Company Law*, (2nd edition, 1997), 314.

<sup>2</sup> *Yeng Hing Enterprise Sdn Bhd v Datuk Dr Ong Poh Kah* [1988] 2 MLJ 60; *Tay Beng Chuan v Official Receiver and Liquidator* [1987] 2 MLJ 419.

opportunity should be given to the directors at a full trial to prove that these requirements have been met.<sup>3</sup>

As regards the first requirement, where a director has acted dishonestly, there is clearly no relief available to him under Section 354(1) of the Companies Act, 1965 (Act 125). The case of *Hytech Builders Pte Ltd v Tan Eng Leong*<sup>4</sup> is an example of such a situation. In *Hytech Builders*, the director diverted a corporate opportunity to a company which he controlled. He also received payments which should have been held for the benefit of the company. He concealed both the diversion of corporate opportunity and the payments from the company. The director was held to be liable to account to the company for breach of the no-profit rule. He applied for relief under the Section 391(1) of the Companies Act (Cap 50, 1994 Ed) (Singapore) which is *pari materia* to Section 354(1) of the Companies Act, 1965 (Act 125). The court found that the director's conduct was dishonest. Accordingly, the court refused to grant relief to the director.

Where the director has acted honestly, there is a need to determine whether the second requirement has been met. This second requirement is whether the director has acted reasonably. In *Re Duomatic*,<sup>5</sup> Buckley J considered the test to be applied in order to ascertain whether the requirement of having 'acted reasonably' is satisfied. The test is how a person, who was dealing with his own affairs with reasonable care and circumspection, could reasonably be expected to act in such a case. This approach was accepted in the case of *Simmah Timber Industries Sdn Bhd v David Low See Keat*.<sup>6</sup> The

<sup>3</sup> *Tay Beng Chuan v Official Receiver and Liquidator* [1987] 2 MLJ 419.

<sup>4</sup> [1995] 2 SLR 795.

<sup>5</sup> [1969] 2 Ch 365.

<sup>6</sup> [1999] 5 MLJ 421.



test appears to be semi-subjective, as the court will take into account the experience and qualifications of the person in question in determining if he acted reasonably.<sup>7</sup>

The question of whether directors should be granted relief arose in *Selangor United Rubber Estates Ltd v Cradock (No. 3)*.<sup>8</sup> The directors who were seeking relief had carried out the instructions of the majority shareholders who had nominated them, without considering the interests of the minority shareholders. They had disposed of virtually the whole of the company's assets blindly. The court remarked that their breach could be said to be dishonest because they put themselves at the disposal of the majority shareholders. However, even if their breach was not dishonest, by blindly carrying out these actions, the directors had not acted reasonably.

Similarly, in *In re Kie Hock Shipping (1971) Pte Ltd*,<sup>9</sup> the director who sought relief argued that he had no power to prevent the breaches of fiduciary duties by his uncle, the managing director of the company. Nonetheless, the director was the executive director of the company. He had taken no action to recover enormous debts owed to the company, and had deprived the company of all possibility of recovering the debts owed. The court found that the argument that the director was powerless to prevent the breaches of fiduciary duty was not a sufficient reason for him to be relieved from liability. The director was found not to have acted honestly and reasonably in his discharge of duties as a director. The court concluded that the director ought not to be excused under Section 354(1) of the Companies Act, 1965 (Act 125).

The third requirement is that the director must show that he ought fairly to be excused, having regard to all the circumstances of the case. This requirement was considered

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<sup>7</sup> Woon, *supra* note 1, 314, citing as an example the case of *Re Haji Ali bin Haji Mohd Noor* [1933] MLJ 135.

<sup>8</sup> [1968] 1 WLR 1555.

briefly in *Selangor United Rubber Estates Ltd v Cradock (No. 3)*.<sup>10</sup> As mentioned earlier, the case concerned the directors' disposal of virtually the whole of the company's assets, without any regard for the minority shareholders. They had acted blindly at the behest of the majority shareholder. In addition to being unreasonable, the court also considered that the acts of the directors were such that they should not fairly be excused.<sup>11</sup>

In contrast, in *Re D'Jan of London Ltd*,<sup>12</sup> the director's breach of duty was considered to be inadvertent. The court remarked that his inadvertence was the kind of thing which could happen to any busy man. Accordingly, the court found that the director ought fairly to be excused for some of his liability. However, it is noted that in this situation, the director had breached his duty of care, rather than his fiduciary duty.

Another example of a fiduciary's behaviour which has been regarded as excusable is found in the case of *Re Ena Jainab Abdeen, Deceased, Julia Ammal*.<sup>13</sup> The facts concerned a breach of trust rather than directors' fiduciary duties. Nonetheless, the criteria for relief of the trustee is similar to the criteria for relief set out in Section 354(1) of the Companies Act, 1965 (Act 125). The trustees in this case were said to have acted reasonably. There was also evidence that adult beneficiaries had been consulted and had agreed to the arrangement in question. Hence, the court found that trustees' actions ought to be excused.

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<sup>9</sup> [1985] 1 MLJ 411.

<sup>10</sup> [1968] 1 WLR 1555.

<sup>11</sup> Similarly, for a fiduciary to stand by and do nothing while property is being dissipated by a co-fiduciary would also be regarded as being unreasonable behaviour that should not fairly be excused; Woon, *supra* note 1, 314-5; *Syed Mohamed bin Ali Alsagoff v Farrer* [1934] SSLR 177; *Chng Joo Tuan Neoh v Khoo Tek Keong* [1932] SSLR 100.

<sup>12</sup> [1994] 1 BCLC 561.

<sup>13</sup> [1930] SSLR 212.



director of the company would be guilty upon contravention of Section 132G by the company, regardless of whether the director concerned had authorised the transaction. Nevertheless, it is argued that such directors may be able to obtain relief under Section 354(1) of the Companies Act, 1965 (Act 125), if they had acted honestly and reasonably.

The second situation, namely, the circumstances in *Re Ena Jainab*, concerned actions of fiduciaries which were reasonable and had been agreed to by beneficiaries. Arguably, the facts of *Regal (Hastings) Ltd v Gulliver*<sup>14</sup> and *PJTV Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd*<sup>15</sup> may have fallen within such parameters. In both *Regal Hastings* and *PJTV Denson*, the companies were unable to complete the transactions, and the directors' intervention by providing personal funds could be said to be reasonable in the circumstances. In *Regal Hastings* it was acknowledged that the directors could have obtained ratification by the company of their breach of the no-profit rule. However, they neglected to obtain the ratification of their breach. The directors were also acting honestly and reasonably in the situation. Arguably, this may be a situation in which the directors ought fairly to be excused under Section 354(1) of the Companies Act, 1965 (Act 125), if it could be shown that the company would have ratified the breach.<sup>16</sup>

In contrast, where a breach of directors' equitable duties cannot be ratified for the reason that it amounts to a fraud on the minority, a director would not be able to obtain relief under Section 354(1) of the Companies Act, 1965 (Act 125). Such a breach would not be honest or reasonable, and could not fairly be excused.

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<sup>14</sup> [1942] 1 All ER 378.

<sup>15</sup> [1980] 2 MLJ 136.

<sup>16</sup> It is noted that this argument was not considered in *PJTV Denson (M) Sdn Bhd v Roxy (Malaysia) Sdn Bhd* [1980] 2 MLJ 136.

In conclusion, relief can only be obtained in limited situations of breaches of directors' duties. Directors must first show that they have acted honestly and reasonably before it can even be considered whether they can fairly be excused. Unlike ratification, relief under Section 354(1) cannot be manipulated by directors to shirk their responsibilities. Requirements of honesty and reasonableness would serve as a safeguard against such manipulation. Further, the court has a discretion as to whether the director should fairly be excused. Relief may be granted in whole or in part, as the court deems fit, with regard to the circumstances of the case.

From the viewpoint of the company, these requirements serve to protect the company's interests. The company would not be deprived of remedies against a director who is in breach of his duties except in situations where the court considers that it is fair. The company is also ensured that unless the breach was also honest and reasonable, Section 354(1) would not relieve a director of liability, and deprive the company of recourse against its director.

## **8.2 Remedies**

In previous chapters, the rules relating to self-dealing by directors have been discussed. These rules include equitable fiduciary principles as well as the statutory provision in the Companies Act, 1965 (Act 125). As seen in Chapter 5, the statutory provisions governing self-dealing by directors provide for various remedies against the directors in situations where directors have contravened the statutory rules. These statutory remedies have been detailed in Chapter 5. Where directors are in breach of the equitable fiduciary rules, civil remedies are also provided for under the general law.



These remedies are in many ways an application of broader principles of equitable relief.<sup>17</sup>

These equitable remedies are available to the company regardless of whether the directors have acted honestly.<sup>18</sup> The remedies which are available for a breach of fiduciary duty are largely dependent on the circumstances surrounding the breach.<sup>19</sup> Such circumstances include the nature of the relationship, the context in which the fiduciary relationship exists, and the context in which the breach of fiduciary obligation occurs.<sup>20</sup> For instance, where a contract is entered into in breach of fiduciary duty, the natural remedy would be rescission of the impugned contract. Likewise, where the director has made a personal profit through a breach of fiduciary duty, the remedy against the director would be for an account of that profit.<sup>21</sup>

### 8.2.1 Rescission

In circumstances where the director has entered into a contract with the company in breach of his fiduciary duty, the company will have the right to rescind the contract.<sup>22</sup> The company may elect to affirm the contract, but unless it affirms the contract subsequent to the discovery of the breach of fiduciary duty, the contract may be rescinded by the company. Affirmation of the contract must be made with knowledge of the breach and of the company's right to rescission.<sup>23</sup> Affirmation should also be made by the company in general meeting, not acting in fraud of the minority.

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<sup>17</sup> Ford, H.A.J. and Austin, R.P., Principles of Corporations Law, (7th edition, 1995), 338.

<sup>18</sup> *PJTV Denson (M) Sdn Bhd v Roxy (Malaysia) Sdn Bhd* [1980] 2 MLJ 136; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

<sup>19</sup> Ford, *supra* note 17, 338.

<sup>20</sup> Kearney, J.B., 'Accounting for a Fiduciary's Gain in Commercial Contexts', In Equity and Commercial Relationships, (Ed. Finn, P.D.), (1987), 187.

<sup>21</sup> *Ibid.*

<sup>22</sup> *Lim Koei Ing v Pan Asia Shipyard & Engineering Co Pte Ltd* [1995] 1 SLR 499.

<sup>23</sup> Ford, *supra* note 17, 339.

The right to rescind the contract may also be lost if the company delays unduly after learning of the breach of duty. In addition, the right to rescission will be lost if *restitutio in integrum* is impossible.<sup>24</sup>

Where a contract is entered into between the company and a third party, the situation is not as simple. The right to elect to avoid the contract may be lost if the rights of innocent third parties have intervened.<sup>25</sup> This is in turn dependent on whether the third parties knew or ought to have known of the directors' breach of duty in procuring the company to enter into the transaction.<sup>26</sup> A transaction is voidable only where the third party knew or ought to have known of the director's breach of duty.

In general a third party or outsider need not inquire whether the directors are acting for an improper purpose.<sup>27</sup> Nonetheless, the outsider or third party may be put on notice of the breach of fiduciary duty. Such notice may be imputed from the nature of the transaction itself. If the outsider has notice of the breach, whether actual or constructive, the company will be have the option of rescinding the contract.<sup>28</sup>

Nonetheless, as regards constructive notice of the breach, it has been suggested that the doctrine of constructive notice should only be applied to commercial dealings with caution.<sup>29</sup> Walter Woon opines that :

*"Where parties are acting at arm's length, the fact that the seller is getting a good deal from the company should not invariably raise the presumption that*

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<sup>24</sup> *In re Leeds & Hanley Theatres of Varieties Ltd* [1902] 2 Ch 809.

<sup>25</sup> *Ibid.*

<sup>26</sup> *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488.

<sup>27</sup> *Royal British Bank v Turquand* (1856) 6 El & Bl 327; *Rolled Steel Products (Holdings) v British Steel Corp* [1986] Ch 246.

<sup>28</sup> *Executive Aids Sdn Bhd v Kuala Lumpur Finance Berhad* [1992] 1 MLJ 89; *Rolled Steel Products (Holdings) v British Steel Corp* [1986] Ch 246.

<sup>29</sup> Woon, *supra* note 1, 297.



he knew of a breach of duty on the part of the directors. The law should not penalize a businessman for driving a hard bargain. It is only where the transaction appears to be clearly against the company's interests and the director appears to be benefitting that an imputation of constructive knowledge should be made.<sup>30</sup>

As for the statutory provisions discussed in Chapter 5, a similar remedy is provided for by Section 132E of the Companies Act, 1965 (Act 125). Section 132E(2) provides that an arrangement or transaction entered into in breach of Section 132E(1) will be voidable at the instance of the company. The company may, however, ratify the arrangement and transaction within a reasonable period. Nonetheless, the Section does not specify whether the factors of *restitutio in integrum* and the intervention of third party rights would affect the company's right to avoid the arrangement or transaction.<sup>31</sup> The other statutory prohibitions on self-dealing, namely Sections 131, 132G, 133 and 133A of the Companies Act, 1965 (Act 125), do not provide for any similar remedy.

### 8.2.2 Account of Profits

As discussed in Chapter 4, fiduciary principles require that a director should not make a personal profit from his fiduciary position. It follows that where a director makes a profit in breach of his fiduciary duties, he is liable to account to the company for the profit made. Similarly, where the director obtains a benefit or profit in circumstances where there was a conflict of interest and duty, the director will be liable to account for the benefit or profit.<sup>32</sup> The profit is recoverable by the company regardless of whether

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<sup>30</sup> *Ibid.*

<sup>31</sup> It is noted that the equivalent provision in the UK statute provides for rescission along the lines of equitable rescission, taking into account *restitutio in integrum* and the intervention of third party rights.

<sup>32</sup> Heydon, J.D., Gummow, W.M.C. and Austin, R.P., Cases and Materials on Equity and Trusts, (4th edition, 1993), 230.

the company has suffered any loss.<sup>33</sup> It is also irrelevant that the profit which is sought to be recovered from the directors was not available to the company.<sup>34</sup>

In *Avel Consultants Sdn Bhd v Mohamed Zain Yusof*,<sup>35</sup> the rule that a director must account for profits made from his fiduciary position was applied. The directors diverted the business of the company to their own firm in breach of the no-profit rule. As a result, they were required to account for all income or profit made in respect of the business which was diverted.

Similarly, in *PJTV Denson (M) Sdn Bhd v Roxy (Malaysia) Sdn Bhd*,<sup>36</sup> the directors were required to account for the profit made as a result of them exploiting a corporate opportunity. This was so, even though the company itself could not have exploited the opportunity due to the lack of funds. The account of profits was required despite the fact that the company did not suffer loss as a result of the directors' breach of duty.

In *Simmah Timber Industries Sdn Bhd v David Low See Keat*,<sup>37</sup> the first defendant, a director, obtained profits for himself by means of an arrangement involving the company. This arrangement involved the transferring of the company's assets to the second defendant. The assets were then leased back by the company. The company paid for the lease of these assets. Through this arrangement, the first defendant obtained various profits, namely payments and a substantial number of shares. The arrangement was in effect a scheme to deplete the company of its assets, whilst providing various benefits to the first defendant. Consequently, the first defendant was required to account for all the profit he received under the arrangement.

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<sup>33</sup> *PJTV Denson (M) Sdn Bhd v Roxy (Malaysia) Sdn Bhd* [1980] 2 MLJ 136; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

<sup>34</sup> *Ibid.*



Nonetheless, there can be no accountability for profit in situations where a director has improperly sold his property to the company at an overvalue. In such circumstances, the company can avoid the contract and recover the purchase money. However, the company may not affirm the contract and claim an account of profit.<sup>38</sup> By affirming the contract, the company would waive its right to claim an account of profits from the directors.

In addition to the equitable remedy of an account of profits, Section 132(3) of the Companies Act, 1965 (Act 125) also provides that a director shall be liable to the company for any profit made by him as a result of a breach of the statutory duty to act honestly and to use reasonable diligence as contained in Section 132(1).

Similarly, Section 132E(3)(a) of the Companies Act, 1965 (Act 125) provides that a director or persons connected to that director shall account to the company for any gain made directly or indirectly from the arrangement or transaction. It is worth noting that an account of profits is not available for a breach of Sections 131, 132G, 133 or 133A of the Companies Act, 1965 (Act 125).

### 8.2.3 Damages or Compensation

In situations where the directors' breach of fiduciary duty causes loss to the company, the company can recover equitable monetary compensation.<sup>39</sup> The purpose of equitable

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<sup>35</sup> [1985] 2 MLJ 209.

<sup>36</sup> [1980] 2 MLJ 136.

<sup>37</sup> [1999] 5 MLJ 421.

<sup>38</sup> *Burland v Earle* [1902] AC 83.

<sup>39</sup> *Ford*, *supra* note 17, 340; *Tavistock Holdings Pty Ltd v Saulsman* (1990) 3 ACSR 502; *Nocton v Lord Ashburton* [1914] AC 932.

compensation or damages is not to punish the director, but to compensate for any loss or damage suffered as a result of failure of some equitable duty.<sup>40</sup>

The equitable principle that the director who breaches his fiduciary duties should compensate the company for loss suffered is seen in a number of cases. In *Bank Bumiputra Malaysia Berhad v Lorrain Osman*,<sup>41</sup> Lorrain, who was found to be in breach of his duty as the chairman of the board of directors, was held liable for all loss suffered by the company as a result of his breach of duty. Along similar lines, the directors in *Avel Consultants Sdn Bhd v Mohamed Zain Yusof*,<sup>42</sup> were also required to pay damages to the company for their breach of fiduciary duty, in addition to accounting for the profit made from their diversion of the company's business.

In *H. Rosen Engineering B.V. v Siow Yoon Keong*,<sup>43</sup> the director, upon learning that his personal investments were about to incur substantial losses, arranged for the company to absorb the losses. As a result, the company was unable to meet its financial obligations and judgment was made against the company for its default in certain payments to third parties. The court ordered the director to pay the judgment debt, in view of the director's breach of fiduciary duty.<sup>44</sup>

Where there is a breach of the statutory duty to act honestly, Section 132(3) of the Companies Act, 1965 (Act 125) also provides for a similar remedy. Section 132(3) stipulates that a director shall be liable to compensate the company for any damage suffered as a result of a breach of the duty to act honestly and to use reasonable diligence in accordance with Section 132(1).

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<sup>40</sup> *Vyse v Foster* (1872) LR 8 Ch App 309, 333, per James LJ.

<sup>41</sup> [1985] 2 MLJ 236.

<sup>42</sup> [1985] 2 MLJ 209.



Along similar lines, Sections 132E(3)(b) and 133(3) provide that the directors involved in the transaction, as well as the directors who authorised the transaction, shall indemnify the company for any resulting loss or damage. The indemnity in Section 132E(3)(b) also extends to persons connected with directors who enter into the transaction or arrangement with the company.

#### 8.2.4 *Constructive Trust*

Where the directors' breach involves improper use of the company's property, and the director retains some asset representing that item, the director is a constructive trustee of the asset. As such, the company has a proprietary claim to that asset.<sup>45</sup> In addition, even where the company is not deprived of an asset, but the director makes a profit from his fiduciary position, such profit obtained by the director is held by him as a constructive trustee.<sup>46</sup>

##### 8.2.4.1 *Third parties*

The company can also trace such assets into the hands of third parties who have knowledge of the relevant circumstances.<sup>47</sup> The first way in which a third party may become a constructive trustee of the company's property is where a third party receives some part of the company's property with knowledge of the breach of duty. This includes actual knowledge as well as wilfully shutting one's eyes to the obvious. It also includes wilfully or recklessly failing to make inquiries which an honest and reasonable

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<sup>43</sup> [1997] 1 CLJ 137.

<sup>44</sup> Although the judge did not discuss principles of equitable monetary compensation, the effect of the decision was to compensate the company for the loss caused by the director's breach of fiduciary duty.

<sup>45</sup> Ford, *supra* note 17, 340; *Paul A Davies (Aust) Pty Ltd v Davies* (1983) 8 ACLR 1.

<sup>46</sup> *Keith Henry & Co Pty Ltd v Stuart Walker & Co Pty Ltd* (1958) 100 CLR 342; Heydon, *supra* note 31, 230.

<sup>47</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 3 MLJ 74; *Selangor United Rubber Estates Ltd v Cradock (No. 3)* [1968] 1 WLR 1555.

person would make.<sup>48</sup> The second way in which a third party may become liable as a constructive trustee is where the third party dishonestly assists the directors in some dishonest and fraudulent breach of their duty.<sup>49</sup> In this second category, the third party's state of mind is crucial. It does not matter if the director is not fraudulent, as long as the third party had dishonest intent.<sup>50</sup>

In *Simmah Timber Industries Sdn Bhd v David Low See Keat*,<sup>51</sup> it was alleged that the second defendant had received monies which he knew, or ought to have known, belonged to the plaintiff company. As a consequence, the plaintiff claimed that the second defendant was a constructive trustee of the monies. The court found that the receipt of the monies by the second defendant was with knowledge of the breach. As such, the monies were deemed to be held by him as a constructive trustee.

### 8.2.5 Injunction

In situations where a breach is threatened but has not yet occurred or where the breach has occurred and threatens to continue, the court may grant an injunction to prevent the breach from occurring or from continuing. Similarly, an injunction would be appropriate where the breach has occurred but the consequences of the breach can be avoided by an injunction. An injunction would then operate to avoid or to minimise the damage to the company.

In *Alor Janggus Soon Seng Trading Sdn Bhd v Sey Hoe Sdn Bhd*,<sup>52</sup> the factors which are considered by the courts in granting an injunction were discussed. Among these

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<sup>48</sup> *Baden v Societe Generale pour Favoriser le Developpement du Commerce et de l'Industrie en France SA* [1983] BCLC 322.

<sup>49</sup> *Royal Brunei Airlines Sdn Bhd v Tan Kok Ming* [1995] 3 MLJ 74.

<sup>50</sup> *Ibid.* Woon, *supra* note 17, 298.

<sup>51</sup> [1999] 5 MLJ 421.

<sup>52</sup> [1995] 1 MLJ 241.



considerations are whether damages would be an adequate remedy.<sup>53</sup> In circumstances where damages are an adequate remedy, an injunction will not be granted. The issue as to whether the plaintiff delayed in instituting the application for an injunction is also regarded as being relevant. In particular, where the delay in applying for an injunction would cause injustice, the courts would hesitate to grant an injunction. Another factor also considered by the courts is the balance of convenience between the parties.

An injunction was granted in the case of *Yukilon Manufacturing Sdn Bhd v Dato' Wong Gek Meng (No. 4)*.<sup>54</sup> In *Yukilon*, two of the directors set up a competing business and diverted the company's business to their own company in breach of their fiduciary duties. The plaintiff sought an injunction against the defendant directors and their companies to restrain them from manufacturing and selling the products similar to the company's products. The court granted an injunction, citing as some of the grounds, the fact that an award of damages would not be adequate compensation and the balance of convenience and justice sided the plaintiffs.

In order for the remedy of an injunction to operate effectively, it is crucial that the remedy should be utilised promptly. This would often be necessary in order to avoid damage to the company. If the remedy is to be used effectively by a shareholder, the shareholder would need to be well-informed about the proposals of the board. This may not often be the case, particularly in larger companies, where many shareholders are not involved in the management of the company.<sup>55</sup>

The only statutory remedy available for a breach of statutory duty which approximates the equitable remedy of an injunction is contained in Section 132E(4). Section 132E(4)

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<sup>53</sup> *American Cyanamid Co v Ethicon Ltd* [1975] AC 396.

<sup>54</sup> [1998] 7 MLJ 551.

<sup>55</sup> Davies, P.L., *Gower's Principles of Modern Company Law*, (6th edition, 1997), 649.

confers power on the court to restrain a company from entering into an arrangement or transaction in contravention of Section 132E(1). The power may be exercised or on the application of any member of the company.

#### 8.2.6 *Dismissal of Directors*

A breach of duty by an executive director could also entitle a company to terminate his services, if the breach is sufficiently serious. In *Ngan Tuck Seng v Ngan Yin Hoi*,<sup>56</sup> the facts of the case involved the director setting up the same type of business which was carried on by the company. The director also misappropriated the company's resources and funds for his own business. The company subsequently removed him as a director. On application to the court, the court held that his breach of fiduciary duty involved the betrayal of the trust underlying the relationship and mutual confidence. Accordingly, there was just cause for his removal as a director.

Similarly, the case of *Houng Hai Kong v MBf Management Sdn Bhd*,<sup>57</sup> involved a director who obtained a secret profit for himself in breach of his fiduciary duties. Consequently, he was dismissed by the company. The Industrial Court held that his breach of duties amounted to gross misconduct which justified his dismissal. This decision was upheld by the High Court.

#### 8.2.7 *Critique of the Remedies*

Equitable remedies cover a variety of possible situations which may be encountered by the company as a consequence of a director's breach of fiduciary duty. The range of remedies available to the company is fairly wide, and are wider than the remedies

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<sup>56</sup> [1999] 5 MLJ 509.

<sup>57</sup> [1997] MLJU 313.



available at common law.<sup>58</sup> These remedies are also relatively flexible.<sup>59</sup> As such, in many situations, the company would frequently be able to choose the remedy which is most beneficial to it. However, it must be borne in mind that the company may not obtain double recovery in respect of any loss. Hence, where there are multiple remedies which would compensate the company for a loss, the company may have to choose one of the options.<sup>60</sup>

As regards the statutory remedies, as discussed in Chapter 5, the statutory provisions provide mainly for criminal penalties. The civil remedies available to the company or aggrieved shareholders for breaches of statutory duties are rather limited. As suggested in Chapter 5, it is submitted that providing for more civil remedies for breach of statutory duties would be beneficial. This is so, especially with regard to the statutory duties of disclosure. Nonetheless, where the directors' actions breach both statutory duties as well as fiduciary duties, the company would still be able to obtain equitable remedies for the breaches of fiduciary duties.

There are unlikely to be problems with regard to the availability of equitable remedies to the company. Rather, the problem which is most likely to arise with regard to remedies stems from those in control of the company refusing to pursue remedies against the directors for breach of fiduciary duties. This may occur particularly where the directors are themselves the holders of the majority of the voting rights of the company. Alternatively, it may also occur where the majority shareholders stand to benefit from the breach, and are therefore disinclined to take action against the errant directors, who may be their nominees.

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<sup>58</sup> Doyle, J.J., 'Commentary', In Equity and Commercial Relationships, (Ed. Finn, P.D.), (1987), 213.

<sup>59</sup> *Id.* 211.

<sup>60</sup> *T. Mahesan v Malaysian Government Officers' Co-operative Housing Society* [1978] 1 MLJ 149.

The shareholders who are most likely to be prejudiced by such a situation would be the minority shareholders. Alternatively, there may at times be shareholders who may not be in the minority, but may be bound by an agreement to exercise their voting rights in limited ways. These, too, may be prejudiced by a decision by those who control the company not to take action against errant directors. Consequently, there is a need to examine the position of these shareholders of the company.

### 8.2.8 Remedies for Minority Shareholders

According to the rule in *Foss v Harbottle*,<sup>61</sup> if a wrong is alleged against the company, the proper plaintiff is the company itself.<sup>62</sup> Further, if the irregularity can be ratified by the majority, the shareholders are not permitted to sue in respect of that irregularity.<sup>63</sup> Shareholders are only permitted to bring an action against the errant directors where the wrong complained of comes within the exceptions to the rule in *Foss v Harbottle*. An example of these exceptions is where there is a fraud on the minority.<sup>64</sup>

Apart from common law, the Companies Act, 1965 (Act 125) also provides for various remedies which may be sought by shareholders against the errant directors. The first of these is found in Section 181 of the Companies Act, 1965 (Act 125). A petition under Section 181 may be made not only by minority shareholders, but also by majority shareholders who are unable to exert their will at a general meeting.<sup>65</sup> Based on this Section, a shareholder<sup>66</sup> may apply to the court on the ground that the affairs of the company are being conducted in a manner oppressive to one or more of the members.

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<sup>61</sup> (1843) 2 Hare 461.

<sup>62</sup> This was applied in *Abdul Rahim bin Aki v Krubong Industrial Park (Melaka) Sdn Bhd* [1995] 3 MLJ 417.

<sup>63</sup> *Abdul Rahim bin Aki v Krubong Industrial Park (Melaka) Sdn Bhd* [1995] 3 MLJ 417.

<sup>64</sup> *Abdul Rahim bin Aki v Krubong Industrial Park (Melaka) Sdn Bhd* [1995] 3 MLJ 417; *Yukilon Manufacturing Sdn Bhd v Dato' Wong Gek Meng (No. 4)* [1998] 7 MLJ 551; *Cook v Deeks* [1916] 1 AC 554.

<sup>65</sup> *Owen Sim Liang Khui v Piasau Jaya Sdn Bhd* [1996] 1 MLJ 113.



Alternatively, a shareholder may apply to court on the ground that the powers of directors are being exercised in a manner oppressive to one or more of the members.<sup>67</sup> Along similar lines, an application can be brought on the ground that the affairs of the company are being conducted, or the powers of directors are being exercised, in disregard of the applicant's interests as a member.<sup>68</sup> On such an application, the court may make such orders as it thinks fit to remedy the matters.<sup>69</sup> The powers to make orders are wide. These powers include the power to regulate the conduct of the affairs of the company in the future.<sup>70</sup> Also included are the powers to prohibit any act or to cancel or vary any transaction.<sup>71</sup> In *Kumagai Gumi Co Ltd v Zenecon-Kumagai Sdn Bhd*,<sup>72</sup> the powers under Section 181(2) were exercised to cancel a transaction and to order a compulsory purchase of a member's shares.

Another statutory remedy available to a minority shareholder is the winding up of the company. Section 217(1) of the Companies Act, 1965 (Act 125) permits a shareholder to apply to wind up the company. According to Section 218(1)(f), such an application may be made on the ground that the directors have acted in the affairs of the company in their own interests, rather than in the interests of the members as a whole. Similarly, the application may be brought if the directors have acted in any other manner which

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<sup>66</sup> The definition of 'shareholder' is wide and includes an ex-member forced out of the company; *Owen Sim Liang Khui v Piasau Jaya Sdn Bhd* [1996] 1 MLJ 133.

<sup>67</sup> *Re Kong Thai Sawmill* [1978] 2 MLJ 227.

<sup>68</sup> *Ibid.*

<sup>69</sup> The factors considered in exercising the powers to make orders were discussed in *Re Kong Thai Sawmill* [1978] 2 MLJ 227. In that case, it was held that the court would take into account the interest of the applicant as well as the interest of other members. It would also consider the possibility of remedying the complaints in ways other than winding up.

<sup>70</sup> Section 181(2)(b).

<sup>71</sup> Section 181(2)(a).

<sup>72</sup> [1994] 2 MLJ 789.

appears to be unfair or unjust to other members.<sup>73</sup> Alternatively, the court may order the company to be wound up if it is of the opinion that it is just and equitable to do so.<sup>74</sup>

Such an action for the winding up of the company was brought in *Indrani C Rajaratnam v Fairview Schools Berhad*.<sup>75</sup> In this case, R.K. Nathan JC concluded that there was a clear finding of fact that the board of directors had acted in their own interests rather than in the interest of the members as a whole. As a consequence, an order was granted for the winding up of the company under Section 218(1)(f) of the Companies Act, 1965 (Act 125).

In *Indrani C Rajaratnam*, the court also adopted the definition of the phrase 'interests of the members as a whole' given in *Foo Yin Shung v Foo Nyit Tse & Brothers Sdn Bhd*.<sup>76</sup> Accordingly, the crux of the phrase seems to be whether the directors are seen to have been acting in the interests of all members, and therefore, in the interests of members as a whole. Where the directors are shown to have preferred their own interests, or the interests of some significant section of the members, they cannot be said to have acted in the interest of all members or the members as a whole. Such actions of directors may be open to challenge, notwithstanding that it may coincide with the interests of the majority shareholder. This would indicate that Section 218(1)(f) would be of particular significance to minority shareholders.

Nevertheless, the winding up of the company is likely to be sought by a shareholder only as a last resort. An application under Section 181 of the Companies Act, 1965 (Act 125) would provide the aggrieved shareholder a far wider range of remedies. The

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<sup>73</sup> Section 218(1)(f).

<sup>74</sup> Section 218(1)(i). See for example *Tay Bok Choon v Tahansan Sdn Bhd* [1987] 1 MLJ 443 and *Tien Ik Enterprises Sdn Bhd v Woodsville Sdn Bhd* [1995] 1 MLJ 769.

<sup>75</sup> [1997] 3 CLJ 460.

<sup>76</sup> [1989] 2 MLJ 369.



powers to make orders under the Section are wide and flexible. As such, remedies may be obtained to suit the particular situation faced by the aggrieved shareholder.

As seen above, minority shareholders have the right of recourse under Section 181 and other provisions. However, a shareholder may hesitate to bring an action under Section 181, for the reason that it would frequently involve substantial costs, in terms of time and money.<sup>77</sup> Further, the shareholder would need to have access to information regarding the dealings complained of in order to take action. Such information may not be readily available to a shareholder who is not in control of the company.<sup>78</sup> In addition, the ability of shareholders to institute proceedings is impaired by the difficulties in acting collectively. A public company, in particular, is likely to have large numbers of shareholders. Litigation involves activity and decision-making of some complexity. As such, there are likely to be significant difficulties in procuring collective agreement for the purpose of proceedings under Section 181 of the Companies Act, 1965 (Act 125) and the other provisions.

Hence, instead of making an application under Section 181 and other provisions discussed above, minority shareholders may often prefer to sell their shares,<sup>79</sup> as it may be the most convenient way of resolving the problems faced by the shareholder. This is likely to be so, particularly with public listed companies, in which one's shareholding

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<sup>77</sup> Farrar, J.H., and Hannigan, B.M., Farrar's Company Law, (4th edition, 1998), 429; Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 61.

<sup>78</sup> *Ibid.* Professor Farrar notes that the suspect transactions are often of a complicated financial nature which the shareholders cannot easily unravel. It may also be difficult to establish precisely what the transaction involves and who are the beneficiaries. The board of directors will usually refuse to disclose any information at a general meeting, on the basis that the matter is confidential and unsuited to discussion at a public meeting. Miles, L., Proctor, G., 'Unresponsive shareholders in public companies: dial "M" for motivate?', (2000) 21 The Company Lawyer 142, 143.

<sup>79</sup> Griffiths, A., 'Shareholding and the Governance of Public Companies', In Corporate Governance and Corporate Control, (Ed. Sheikh, S. and Rees, W.), (1995), 66; Farrar, *supra* note 76, 429; Miles, *supra* note 77, 143.

may easily be disposed of.<sup>80</sup> Nonetheless, by selling their shares, shareholders are able to exert a certain degree of influence over the management of the company. Shareholders of a public listed company are able to affect the company's share price through their ability to sell their shares.<sup>81</sup> This in turn may result in adverse publicity for the management, and may potentially increase vulnerability to a takeover bid.<sup>82</sup> This influence exercised by shareholders through market forces is known as the 'market in corporate control'.<sup>83</sup>

Where a dissatisfied shareholder disposes of his shares on the grounds of abuse of the directors' position, this may provide relief from the problem to that shareholder. However, this does not deal with the deeper underlying problem of directors' abusing their position.<sup>84</sup> Admittedly, shareholders may indirectly exercise some influence on the situation by selling their shares. Nevertheless, the problem of directors abusing their positions is likely to persist, if stricter measures are not taken against such directors. Consequently, if abuse by directors is permitted to continue, this is likely to subtly erode the confidence of investors in our capital markets, and undermine the value of our capital markets as investments.

### 8.2.9 Institutional Shareholders

The disabilities faced by minority shareholders in influencing those in control of the company, as discussed above, stem primarily from the separation between ownership

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<sup>80</sup> Pennington notes that the position of a minority shareholder of a private company who is not a director is much weaker than that of a shareholder in a public company which has a Stock Exchange listing for its shares. A minority shareholder of a private company cannot readily sell his shares if he is dissatisfied with the management, for the reasons that the articles of association of a private company restricts the transfer of shares and the lack of an available market; Pennington, R.R., *Company Law*, (7th edition, 1995), 1025.

<sup>81</sup> See for example Johari S., 'UEM shares fall to lowest level in 19th months', *Business Times*, 13 December 2000; Long, H.C., 'UEM fined RM100,000 on Renong purchase', *New Straits Times*, 19 February 1998.

<sup>82</sup> Griffiths, *supra* note 78, 62.

<sup>83</sup> *Id.* 67.



and control of the company. Nevertheless, a positive development which mitigates some of the problems arising from the separation between ownership and control has begun to take place. This is brought about by the emergence of the institutional shareholder.

The trends in the United Kingdom, Australia, New Zealand, the United States and Canada indicate significant growth of institutional investors increasing their holding of shares in public listed companies.<sup>85</sup> In Malaysia, it has been estimated that by early 1997, a quarter of the shares listed on the Kuala Lumpur Stock Exchange were held by Malaysian institutions, and another quarter were in foreign hands, including foreign institutional investors.<sup>86</sup>

It has been observed that some of the largest shareholders in large public listed companies tend to be financial institutions, including insurance companies and pension funds.<sup>87</sup> The large shareholdings of these institutions constitute a power bloc within the company. What is unique is that this trend of institutional shareholding has been found to apply across the board, and is not limited to one company or to a sector of industry.<sup>88</sup> Hence, where there has been a separation between the ownership and control of companies particularly with the minority shareholders of public listed companies, with the emergence of institutional shareholders, there is an increasing regrouping of ownership with potential control.

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<sup>84</sup> Miles, *supra* note 77, 143.

<sup>85</sup> Farrar, *supra* note 76, 578. In the United Kingdom, institutional investors increased their market share of UK-listed equities from 17.9% in 1957 to 60.4% in 1992. It is estimated that they are acquiring about 2% of the UK equity market each year. It is also estimated that institutions in the United Kingdom currently hold about 60% of the shares in listed UK companies. Individuals hold approximately 20% and the remainder is held by non-UK institutions.

<sup>86</sup> Chin, K.F. and Jomo. K.S., 'Financial Liberalisation and System Vulnerability', In Malaysian Eclipse: Economic Crisis and Recovery, (Ed. Jomo, K.S.), (2001), 107.

<sup>87</sup> Farrar, *supra* note 76, 565.

<sup>88</sup> *Id.* 581-2.

Given that institutional shareholders would often have a significantly large shareholding, they would have the voting power to influence resolutions which are put before shareholders of the company. Similarly, institutional shareholders are likely to be able to influence the share price of the company should they decide to sell their stake in the company.<sup>89</sup> In view of this, they are in a much better position than minority shareholders to exercise influence over those in control of the company.<sup>90</sup> Consequently, where there are transactions suspected of involving self-dealing by directors, these institutional shareholders would potentially be able to engage in discussions with the directors to extract details of the transactions and bring the directors to account.<sup>91</sup> Even if institutional shareholders do not go so far as to institute legal proceedings in relation to self-dealing, they could nonetheless bargain in the shadow of the law. Thus, the legal rights of the company and its shareholders would to some extent be realised.

Although the potential power of institutional shareholders is evident, there appears to be some reluctance on the part of institutional shareholders to exercise this influence. One of the reasons for this is that the primary responsibility of these institutional investors, many of whom are financial institutions, is to achieve maximum investment performance.<sup>92</sup> The objective of their shareholding is one of investment rather than to engage in the management and control of the company. Further, their expertise is in finance rather than management.<sup>93</sup>

Recognition of the potential influence of institutional shareholders over those in control of companies has attracted various responses calling for institutional shareholders to

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<sup>89</sup> *Id.* 581.

<sup>90</sup> Miles, *supra* note 77, 143.

<sup>91</sup> Finance Committee on Corporate Governance, *supra* note 76, 74.

<sup>92</sup> Farrar, *supra* note 76, 580-1; Miles, *supra* note 77, 143.

<sup>93</sup> *Ibid.*



use their influence to ensure that the management carry out their duties.<sup>94</sup> In the United Kingdom, institutional shareholders have responded by forming institutional shareholders' committees. One of the major functions of these committees is to issue position statements, codes and guidance notes on behalf of its members on contemporary issues which its members feel strongly about.<sup>95</sup> The efforts by institutional shareholders to influence corporate governance appears to have been effective. Preliminary indications show substantial changes in corporate governance along the required lines, since the publication of such statements and other documents.<sup>96</sup> Various other instances of effective institutional shareholder activism have also been documented.<sup>97</sup>

#### 8.2.10 Conclusion

The examination of the available remedies for a breach of directors duties indicates that there are ample remedies available to the company. Nonetheless, there are a number of impediments to the enforcement of these remedies.

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<sup>94</sup> The Finance Committee on Corporate Governance remarked that given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance. Institutional shareholders should take a positive interest in the composition of boards, with checks and balances. The Committee also recommended that local institutional shareholder associations should formulate guidelines for the development of a constructive relationship between the company and the owner; Finance Committee on Corporate Governance, *supra* note 76, 60, 68, 100; See also Committee on the Financial Aspects of Corporate Governance, Report of the Committee on the Financial Aspects of Corporate Governance, (December 1992) (the Cadbury Committee report); Potter, J., 'The role of the Institutional Shareholders' Committee', In Corporate Governance and Corporate Control, (Ed. Sheikh, S and, Rees, W.), (1995), 288.

<sup>95</sup> Potter, *supra* note 93, 285.

<sup>96</sup> *Id.* 290.

<sup>97</sup> One of these is the Thalidomide case. This case concerned the former management of Distillers Company Ltd who resisted public pressure to settle with victims on more generous terms. As a consequence, the market price of their shares fell. The institutional investors together with the company's merchant bankers met with the senior management, after which the company increased its offer. This formed the basis of the ultimate settlement of the matter; Farrar, *supra* note 76, 580.

The first of these obstacles arises from the rule in *Foss v Harbottle*.<sup>98</sup> As a result of this rule, it is clear that the entity who would be entitled to bring proceedings against errant directors for self-dealing would be the company. Nonetheless, where the directors who are engaged in self-dealing are themselves in control of the company, they may refuse to bring such proceedings. Where these directors are themselves the controlling shareholders of the company, the other shareholders are left with little recourse against the errant directors, unless the matter falls within one of the exceptions to the rule in *Foss v Harbottle*.<sup>99</sup>

The other obstacle to obtaining remedies against the errant directors would be ratification of the breach of directors' duties by the company, as discussed in Chapter 7. The law at present would appear to allow the wrongdoers to exercise their voting rights as shareholders to ratify their wrongs.<sup>100</sup> Again, where the errant directors are able to exercise or influence the exercise of sufficient votes at a general meeting to obtain a ratification of the breach, other shareholders would be left in a disadvantaged position.<sup>101</sup>

Minority shareholders have other rights available to them under Sections 181 and 218(1)(f) and (i) of the Companies Act, 1965 (Act 125). However, there are significant practical difficulties in bringing proceedings under these provisions, as discussed in Section 8.2.8 above. Consequently, a common response of minority shareholders to

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<sup>98</sup> (1843) 2 Hare 461.

<sup>99</sup> *Ibid.*

<sup>100</sup> *Tuan Haji Ishak bin Ismail v Leong Hup Holdings Berhad* [1996] 1 MLJ 661; *Guyler Magruder v Creative Software (M) Sdn Bhd* [1994] MLJU 107; *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589; *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133.

<sup>101</sup> It is noted that where the breach amounts to a fraud on the minority the breach would be unratifiable; *Cook v Deeks* [1916] AC 554. However, minority shareholders would face practical impediments in bringing legal proceedings to challenge such ratification, as with other litigation.



self-dealing would be to sell their shares, rather than to bring legal proceedings for remedies against errant directors.

Hence, with minority shareholders, it is evident that there is a wide gap between the remedies available for a breach of directors' duties in theory on the one hand, and practical reality on the other. The one redeeming factor would appear to lie in the hands of institutional shareholders, who have a concentration of shares, and are consequently not bound by the constraints faced by minority shareholders. The deciding element here would not be the lack of potential power to enforce the legally available remedies. Rather, it would depend on the willingness of institutional shareholders to make the necessary paradigm shift in their perception of their shareholding, and to rise up to the challenge of utilising their potential influence.

## CHAPTER 9 - CONCLUSION

The corporate scene has seen significant changes in modern times. Among the pertinent changes is the increase in the separation between the ownership and control of companies, evidenced particularly by the growth of public listed companies. This separation between ownership and control, coupled with the increasingly elaborate structures of corporate conglomerates, increases the potential for self-dealing.

The separation of ownership and control, coupled with the complex corporate structures of many public listed companies, typically leaves the control of the company in the hands of a few controlling shareholders and their nominee directors. Conversely, minority shareholders frequently lack the ability to influence the decision-making or control of the company. Minority shareholders are often similarly faced with a dearth of information concerning the affairs of the company, leaving them further crippled in their ability to exercise any influence over the management of the company. Consequently, the directors of a modern company are able to manage the affairs of the company, and deal with its assets, relatively free from the interference and scrutiny of minority shareholders. As a result, the potential for self-dealing by directors is significantly increased.

The modern company has needs which differ from the traditional company. In order to remain relevant and effective, company law should develop in accordance with these changing needs. The greater potential for self-dealing in modern companies creates a need for changes in the law in order to address the issue of self-dealing. These changes should address, firstly, the need for information, particularly to minority shareholders. Hence, there is a need to require disclosure of information regarding the affairs of the



company. Secondly, the greater potential for self-dealing necessarily heightens the need for stricter regulation of self-dealing by directors.

The need for law reform is also heightened by the inadequacies in the existing law on self-dealing by directors. As noted in Chapters 3 and 4, an examination of the equitable no-conflict and no-profit rules indicates that the equitable rules against self-dealing are in some respects ambiguous. In some areas, the case law is unsettled. Although these equitable rules embody principles which significantly address the essence of self-dealing, companies would benefit from clarification of these principles. This is so, particularly in relation to areas such as the exploitation of corporate opportunity.

The existing legislation regulating self-dealing provides little assistance in clarifying the equitable rules. A significant contribution of the legislative provisions is its specific regulation of particular instances of potential self-dealing. These include loans to directors, as well as acquisitions of property from directors, disposals of property to directors, and persons connected with directors. Nonetheless, the situations dealt with by the legislative provisions are limited to a number of overt situations of self-dealing. Notably, the legislation fails to deal with indirect schemes involving self-dealing, such as quasi-loans and transactions made through a number of layers of nominees of directors. The provisions leave room for various schemes which may be used to circumvent the legislative provisions.

The above reflects significant inadequacies of the existing rules on self-dealing. There is, consequently, a clear need for legislative reform of the rules on self-dealing. Nevertheless, whilst statutory regulation is necessary, the danger of over-regulation should be borne in mind. Excessive regulation of companies has the potential of stifling

their development.<sup>1</sup> As such, although some legislative reform is necessary, some room should also be left for market regulation.

The Finance Committee on Corporate Governance in its report acknowledged the need to move away from traditional prescriptive legal rules, towards a market-oriented economy. Hence, the Committee advocated a shift to a disclosure-based regime. The Committee proposed a Malaysian Code on Corporate Governance which is aimed at encouraging disclosure and providing information to investors to enable them to monitor the way companies are being run.<sup>2</sup> Accordingly, companies are given sufficient flexibility in implementing principles of corporate governance. At the same time, this addresses one of the major difficulties faced by shareholders resulting from the separation between ownership and control, namely the lack of information on the management of the company. Shareholders are, hence, facilitated in their exercise of influence through the 'market in corporate control'.

In relation to the disclosure-based regime, it is submitted that disclosure of information on the subsidiaries of public companies is also relevant.<sup>3</sup> These subsidiaries are in reality a part of the entity through which public companies operate. In such situations, it is submitted that the corporate veil should not be used to conceal self-dealing. Rather, practical realities suggest that subsidiaries of public companies should similarly be subject to the scrutiny of shareholders.

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<sup>1</sup> The Australian Stock Exchange (ASX), in relation to the Corporate Law Review Bill 1997, noted that companies' circumstances are diverse, and it is not possible to identify meaningful corporate governance practices and disclosure that can apply across the diversity. The ASX warned that a prescriptive or intrusive approach to corporate governance would be a danger and would restrict companies' abilities to follow world best practice as it continues to evolve; Parliament of Australia, Senate Committee Report on the Corporate Law Review Bill 1997.

<sup>2</sup> Finance Committee on Corporate Governance, Report on Corporate Governance, (February 1999), 59. See also Sheikh, S., Rees, W., 'Corporate Governance and corporate control: Self-Regulation or Statutory Codification', In Corporate Governance and Corporate Control, (Ed. Sheikh, S., Rees, W.), (1995), 384.

<sup>3</sup> This issue is discussed in greater detail in Section 5.4.1 of Chapter 5.



Nonetheless, the 'market in corporate control' has its limitations. It deals with issues of self-dealing indirectly, but fails to directly bring errant directors to account. If self-dealing is left to continue without errant directors being made to account for their wrongs, ultimately, it is the company that will suffer. Despite the difficulties of enforcing the company's rights and remedies in situations of self-dealing, litigation or bargaining in the shadow of the law in order to curb self-dealing by directors plays an important role in deterring self-dealing. It is in this respect that institutional shareholders play a significant role. Institutional shareholders frequently hold sufficiently substantial shareholdings to apply the necessary pressure to cause directors to abide by their duties.

The question as to the extent to which legislative intervention should be utilised and how much room should be left to market forces arises when specific measures for reform are considered. This is an issue to which there appears to be no clear-cut answers. The balance between the two measures forms the subject of perennial debate.<sup>4</sup> In considering the balance between the two measures which should be adopted in Malaysia, it would be prudent to keep in mind cultural factors and the individual circumstances of our corporate scene.

The study of the existing law regulating self-dealing by directors leads to the finding that there is a need for reform of the existing laws. This is more so, in view of the share market's major role in the Malaysian financial system.<sup>5</sup> Protection of shareholders'

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<sup>4</sup> See for example Parliament of Australia, Senate Committee Report on the Corporate Law Review Bill 1997, in which the opposing views regarding the level of shareholder protection and the adequacy of corporate governance structures were noted. It was remarked that both sides made reference to world best practices and corporate governance models in other countries.

<sup>5</sup> Jomo, K.S., 'From Currency Crisis to Recession', In Malaysian Eclipse: Economic Crisis and Recovery, (Ed. Jomo, K.S.), (2001), 41; Chin K.F. and Jomo, K.S., 'Financial Liberalisation and System Vulnerability', In Malaysian Eclipse: Economic Crisis and Recovery, (Ed. Jomo, K.S.), (2001), 103; Lim S.Y., 'The Savings-Investment, Corporate Financing Needs and Capital Market Development', In Malaysia's Vision 2020: Understanding the Concept, Implications and Challenges, (Ed. Ahmad Sarji Abdul Hamid), (1993), 261.

investments in companies from abuse by directors is regarded as being of major significance to the strength and competitive edge of the Malaysian economy.<sup>6</sup>

In conclusion, there is a clear need for the reform of the existing law. Statutory reforms play an invaluable role in strengthening the laws against self-dealing. Similarly, reforms through the influence of market forces and the fostering of disclosure and transparency play an equally significant role in reducing the undesirable occurrence of self-dealing by directors. It is hoped that the measures proposed in this study will contribute to the strengthening of the regulatory regime aimed at deterring self-dealing by directors.

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<sup>6</sup> Ramly Bin Haji Ali, 'The Rules of Good Corporate Governance: Methods of Efficient Implementation', 12th Commonwealth Law Conference, Kuala Lumpur 13-16 September 1999; Securities Commission, 'Strengthening the Capital Market Regulatory Framework: Why Regulate in the first place?', The Securities Commission Business Plan 1998-2000.



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